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COVERED BONDS: POTENTIAL USES AND REGULATORY ISSUES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

ON

EXAMINING COVERED BONDS, THEIR POTENTIAL USES, AND REGULATORY ISSUES

SEPTEMBER 15, 2010

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C O N T E N T S

WEDNESDAY, SEPTEMBER 15, 2010

WITNESSES

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

COVERED BONDS: POTENTIAL USES AND REGULATORY ISSUES

WEDNESDAY, SEPTEMBER 15, 2010

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Well, good morning, everyone. The Committee will come to order, and let me first of all welcome all of you to the Committee room. It is good to see my colleagues once again after the August break and the rather hectic year we have had with all the legislative efforts. So it is pleasant to see everyone, and this morning we are going to have a hearing on covered bonds, the potential uses and regulatory issues.

Just as background to this—and I will make a brief opening statement. We are waiting for Congressman Garrett to come up. He is the individual in our conference who raised this as an amendment during the conference consideration. Senator Corker expressed a great deal of interest in this subject matter, as did others, and there was some opposition to including his language in the bill at the time from a number of the regulators and others. So I was uneasy about putting something in where there was that much debate about the subject matter, but agreed to have a hearing exclusively on the subject matter, which we will do here today, and we have got some wonderful witnesses who can shed, I hope, some very worthwhile light on the subject matter.

And so I am grateful to Congressman Garrett for raising the issue, grateful to Senator Corker for calling for us to have a hearing on it so we can examine the issue; and while we do not intend necessarily to resolve the matter in the next few days, it is an important subject, and this is a vehicle that is used by a lot of our European allies. It is a common vehicle used, and there are a lot of positive things about covered bonds, but there are some questions obviously others will have as well about their usage.

So let me open with some comments. I will turn to Senator Shelby, and by that time, we hope Congressman Garrett can be here. Then we will hear his testimony and get right to our panel.

Today the Committee will hear testimony on covered bonds, as I have indicated, a potentially significant alternative means for raising capital for housing finance. Covered bonds have been issued

widely in Europe for many years, but not in the United States. The purpose of today's hearing is to learn more about covered bonds, exploring whether they could contribute to sustained economic growth and whether it is in the public interest to encourage their broader use in our own country.

The hearing grew out of a discussion, as I mentioned a moment ago, on covered bonds that came up during the latter part of the Senate–House conference on the so-called "Dodd-Frank Act." I am pleased to have worked with Ranking Member Shelby and Senator Corker, as I have mentioned, in organizing this hearing. As the Banking Committee has not previously held a hearing on covered bonds, and the subject has raised issues among Federal regulators, we determined to explore the matter more carefully before acting.

When speaking of covered bonds in the United States context, we generally mean a debt security issued by a bank and backed by cash-flows from mortgages or public sector loans. The bond is backed by the bank's promise to repay and by the assets pledged in collateral. Covered bonds can provide an additional option to the two dominant funding mechanisms in the U.S. marketplace, which are securitization and the traditional portfolio lender model, where a bank holds mortgages on the balance sheets and funds them with deposits.

Proponents of covered bonds point to their greater transparency because these assets remain on a bank's balance sheet so investors can analyze their value more easily than in the case of some other asset-backed securities. Proponents also note that issuers of covered bonds have a long-term interest in the underlying loans because they keep them on their balance sheet, which increase investor confidence.

While American banks are not prohibited from issuing covered bonds to raise capital, few currently do so. Some potential investors are concerned about the treatment of covered bonds if the issuer goes into conservatorship or receivership. They believe that legislation and agency rulemaking are needed to provide clarity about how covered bonds would be regulated. Any such measures would define the rights and responsibilities of investors, issuers, and regulators. They feel that this would stimulate the growth of a later domestic covered-bond market.

It is important that Congress, I think, look for alternative means and measures that could stimulate the economy. The Committee is holding today's hearing to learn more about this alternative and whether it could contribute to safe and stable and sustained economic growth.

We are pleased to have before us experts who will provide testimony about the history of covered bonds, their uses and potential benefits, as well as their interaction with existing mortgage financing mechanisms. The panel also includes Federal regulators who can share their perspective on the regulation of banks that would issue covered bonds, including the impact on the Deposit Insurance Fund.

On the first panel, I am pleased to welcome Congressman Scott Garrett. Here you made it. I am glad you got over here. I was going to filibuster for a while until you got here, something we do with some regularity around here these days. Welcome to the Senate

side, Congressman. Nice to see you again as well, by the way. We spent an awful lot of time together, it seems, not long ago. Anyway, delighted you are here.

Congressman Garrett has a strong interest in this area—spoke eloquently about it during our conference with the House on the financial reform bill—and has introduced legislation on covered bonds.

On the second panel, we will hear from Julie Williams, Chief Counsel and the First Senior Deputy Comptroller, Office of the Comptroller of the Currency; Michael Krimminger, who is Deputy to the Chairman of the Federal Deposit Insurance Corporation; Scott Stengel, on behalf of the U.S. Covered Bond Council; Professor Kenneth Snowden, from the University of North Carolina at Greensboro; and Mr. Ric Campo, on behalf of the National Multi Housing Council and the National Apartment Association.

Last, let me just say just as what I see as kind of the issues, and I will just pick seven issues here that it would seem to me to help our panelists—I do not expect you all to answer every one of these, but these are the questions we thought were legitimate to be raised here.

One, is legislation needed? A pretty basic question, but one that I think should be raised. What entities would be eligible to issue covered bonds? What agencies should regulate covered bonds? What assets would be eligible for covered bonds? What standards should apply to issuance, joint rulemaking, cap on assets held in covered bonds, limit of percentage of covered bonds as to total liabilities, minimum collateralization? What are the consequences of a failure of a covered-bond issuer or a bond default? And what securities disclosures would apply?

Now, there may be more issues, but those are six or seven we thought were legitimate questions to be raising about this subject matter.

So, with that, let me turn to Senator Shelby for his opening comments, and then unless my two colleagues want to be heard on the matter, we will go right to Congressman Garrett. Richard.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I appreciate that you are fulfilling the commitment that you made during the financial regulation conference to hold this hearing. The fact is our housing policies have failed on a grand scale. Fannie and Freddie are in Federal hands, while millions of homeowners continue to struggle with mortgages that are underwater. Taxpayers have lost over $200 billion and are likely to lose billions more in the future. Despite this, the proponents of reform legislation chose to ignore many of the problems in the mortgage market, I believe. I believe this was a serious mistake and think this Committee must remain engaged in the hard work necessary to come up with solutions that protect taxpayers and homeowners alike.

A thorough examination of the use of covered bonds I think is a positive first step. A covered bond, Mr. Chairman, as you have mentioned, is a financial instrument that merits this Committee's close scrutiny. When implemented under certain regulatory and

economic circumstances, they have proved to be a valuable private sector tool for providing mortgage liquidity in certain markets.

However, what works in some markets does not always translate well to our economy. Additionally, as is noted in the testimony of members of the second panel, and contrary to popular perception, covered bonds have been tried in this country before, and they did not achieve a high level of success. Nonetheless, the Committee should thoroughly study this unique area of mortgage finance. Only then can we conduct our own analysis of this particular approach and determine whether covered bonds should become a part of our housing finance landscape.

But I believe before we proceed with the testimony, Mr. Chairman, I want to reiterate my belief that, notwithstanding the recent passage of the Dodd-Frank bill, this Committee has a great deal of work yet to do. Our housing finance markets have been crippled, and the bureaucratic structure that has been erected as a result of decades of ill-advised housing policies has only made it worse.

Mr. Chairman, I think the American people are fed up. They are fed up with bailouts, excessive debt, and oversized Government. They are certainly fed up with an anti-State mentality that demands a new Federal program for every identifiable problem in the housing sector. Therefore, Mr. Chairman, I believe we must completely reevaluate our current approach to housing policy and find the political courage to make some significant changes. My hope is that this hearing is the beginning of that process.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Yes, Senator Corker.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. I want to break the Corker rule and just very briefly say that I want to go back to comments I made last November or December and say that this type of hearing is exactly the reason that I think this is a great Committee. And I think at the time of conference we did not have the information we needed. A commitment was made by you to have this hearing and we are having it, and I appreciate that. And, again, I think it is part of the thoughtful approach that we have used on most issues. I know last year was a very tumultuous year, a lot of emotions frayed. But, Scott, I want to thank you for championing this issue and pressing it as you have. I know that you have already passed a piece of legislation in the House. We did not know as much as we needed to know about it and had some questions, and I think it is appropriate that we are having a hearing, and I think this is a first step toward addressing some of the issues that Senator Shelby has raised.

So I want to thank you for having the hearing.

Chairman DODD. Thank you, Senator, very much.

Jack, any comment?

Senator REED. For the record, Mr. Chairman, I would like to follow the Corker rule.

[Laughter.]

Senator SHELBY. Now, the Corker rule is unwritten, isn't it, Mr. Chairman?

Chairman DODD. It is an unwritten, rigid rule. And I suspect that as this gavel may move back and forth here that the people are going to want to apply it with greater regularity.

Senator SHELBY. And the Corker rule is very much in vogue when we have got a full panel of members.

Chairman DODD. Oh, very much in vogue.

Senator SHELBY. Of members.

Chairman DODD. Yes, absolutely, want to talk. First of all, on the subject matter I am sure not a lot of them know what a covered bond is yet, too. That may slow them down on opening statements along the way.

Anyway, Congressman, welcome to the Senate. We are anxious to receive your testimony.

STATEMENT OF SCOTT GARRETT, REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mr. GARRETT. Well, first of all, thank you, Chairman Dodd and Ranking Member Shelby. Thank you very much for inviting me here and for holding this hearing as well, and thank you, Senator Corker, for being a strong and articulate advocate for covered bonds as well. I appreciate your assistance on this very important issue.

As our Nation continues, in essence, to recover from the recent financial crisis and certain credit markets remain locked, Congress really must—and I think the Chairman agrees—examine new and innovative ways to encourage the return of private investment to our capital markets. So we must also consider creative ways to enable the private sector to provide additional consumer and commercial and public sector and other types of credit as well. So establishing this U.S. covered-bond market would further all these shared goals.

One reason I am really particularly fascinated with covered bonds is the fact that they can be a purely private means of finance—and this is important—without any Government guarantees or subsidies. Many proposals to help alleviate the current strains in our credit markets focus on Government loans or guarantees. However, I believe that covered-bond legislation offers a way for the Government to provide additional certainty—and some are looking for it—to private enterprises and generate increased liquidity through the innovation of a new marketplace without, again—and this is important—putting the taxpayers on the hook.

Now, there are many potential benefits for a wide variety of interested parties that can be derived from a U.S. covered-bond market. I think the Chairman was touching on some of these.

Consumers will experience lower loan rates because of the additional liquidity in the various asset classes.

Consumers will also be able to more easily have their loans modified because the loans will still be on the balance sheets, on the books of the originating institution.

Investors will have a new transparent and secure vehicle to invest in, and this will allow for additional diversification within their portfolios.

And, finally, the broader financial market itself will benefit by having an additional, low-cost, diverse funding tool for all financial institutions there.

Covered bonds will ensure more stable and longer-term liquidity in the credit markets, which reduces refinancing risks as well as exposure to sudden changes in interest rates and investor confidence. And they will allow U.S. financial institutions to compete more effectively against their global peers.

In the House, we have worked in a very constructive bipartisan fashion to push the ball forward on comprehensive covered-bond legislation. I just left Chairman Kanjorski and Ranking Member Bachus, and I have introduced three different versions of covered-bonds legislation. The most recent is H.R. 5823, the Covered Bond Act of 2010.

Now, a week before the August recess, we successfully marked up this legislation and reported it out of Committee with a unanimous vote. It is my hope that we can pass this legislation out of the House over the next several weeks.

Some have asked why we need covered-bond legislation. You raised seven points. Simply, to get the market off the ground and provide investors with the needed confidence to invest in the market and resolution procedures of a bond when an issuer fails needs to be spelled out specifically in statute. Otherwise, without the certainty of a legally binding process, there is not significant enough appetite from the investment community to make covered bonds cost-effective to the issuers to offer. Also, a regulatory regime needs to be put in place to ensure proper oversight of the marketplace.

Throughout this process, there have been some people who have said, "Well, let us wait and see; maybe next year with housing finance reform." But the proposal we are discussing today is broader than just housing finance. Covered bonds offer a complementary source of funding that can spur much needed lending to consumers, small businesses, and State and local governments. The reason why I have been so active in pushing covered bonds this year is because I believe we have to do it right now. We hear almost daily about the liquidity concerns throughout various asset classes. The House Financial Services Committee held a recent hearing about the lack of liquidity in the marketplace. The Senate just passed a bill already approved by the House with the intent of providing more liquidity.

Also, we have spoken to local and State officials about the problems municipalities face with increased funding costs for their projects. The President has continuously stressed the need to help these segments of the economy. More importantly, this is something we can do, we can do it now, and we do it without any cost to the taxpayer.

Another reason to move quickly on establishing a covered-bond market in the U.S. is because billions of U.S. investment dollars are moving overseas and north of the border. So far in 2010, there have been a dozen covered-bond deals issued by foreign banks to U.S. investors totaling over $18 billion. This is private capital that could have been invested here in the United States with the help of our legislation.

Private industry realizes that we are currently missing out on an opportunity as well. Now, I have formal letters of support for the U.S. Covered Bond Act from the National Association of Realtors, the Mortgage Bankers Association, the ABA, the National Multifamily Housing Council, and so on.

Now, finally, I do not want to pretend to believe that covered bonds are some sort of magic bullet that will help solve all of our funding needs. However, what I do know is this: that they will help solve some—some—of our funding needs. What I do know is that during this time of economic uncertainty, lack of liquidity, and rising budget deficits, during all this time we must consider innovative approaches to help attract private investments—not Government investments—into our capital markets. I believe that this legislation can help us out in that regard.

I will end where I began. I want to thank the Chairman so very much and the Ranking Member as well for this invitation, for taking up this issue, and for considering this important piece of legislation.

Thank you, Senators.

Chairman DODD. Thank you, Congressman, very, very much, and I congratulate you on your efforts in the House and getting things moving along in this area.

Let me turn to my colleagues if they have any questions of our colleague in the House. Jack, any questions at all?

Senator REED. No. I just want to commend the Congressman not only for his work here today but for his major contribution to the conference committee on financial reform. Thank you, Congressman.

Chairman DODD. Yes, and I should have said that as well.

Mr. GARRETT. Well, that was made more fun because of the Senators.

[Laughter.]

Chairman DODD. I know. I know how much you like to have us come over to the House side.

Mr. GARRETT. We do.

Senator CORKER. I know we do not typically question, you know, people who are elected officials, and so I am not going to do that. But you might want to get some editorial comment as to what—I know what passed in the House was not perfect in your eyes. Would you share with us a couple of things that you think might make the bill you passed in the House more perfect?

Mr. GARRETT. How would we make the bill——

Senator CORKER. I know you had to make some compromise in the House that you did not really want to make. Could you share with us a couple of the things that you think would make the bill that passed in the House better if we passed it in the Senate?

Mr. GARRETT. Well, I will just touch on one. One aspect is with regard to asset classes in the legislation. Our background on this looks to Europe. They use this for their asset classes. We take a broader approach to that. And some say maybe we are taking too broad an approach. So we agreed to come to agreement, come to a compromise on that, and rein that in somewhat. But I think we did it in a constructive manner to allow the regulators some degree

of flexibility going forward as the marketplace expands and develops and they have the understanding of the operation there.

But I do believe going forward, just as I said in my testimony, that this really is not an issue just in the mortgage/housing finance situation. This can be an avenue for increased liquidity and increased credit and a whole slew, if you will, of different asset classes as well. So that is one area that we could take a look at.

Senator CORKER. And right now it is mortgages only. Is that correct?

Mr. GARRETT. Oh, no. We have limited it, but we have not extended it to a *carte blanche* avenue in the bill.

Senator CORKER. OK. Thank you, Mr. Chairman.

Chairman DODD. Congressman, thank you very, very much.

Mr. GARRETT. Thank you.

Chairman DODD. Let me invite our panel to come up and join us. I have already introduced, I think, the panel so I will ask you to come up and assume the seats in the order in which I introduced you.

While our witnesses are taking their seats, the staff has pointed something out to me that we do not do often enough, in my view. In the case of Mr. Krimminger and Ms. Williams, these are people who have dedicated a good part if not all of their professional life to the service of our country. Julie Williams has worked for almost 30 years for the Federal Home Loan Bank, the OTS, and the OCC. Where are you? There you are at the end down there. Very fond of people who—young people with gray hair. I have a bias to that coloration. And Michael Krimminger has worked for almost 20 years as well for the Government, and we thank you both for your service to our country, day in and day out just trying to do a good job on behalf of the Nation. We are very fortunate to have your service, and I thank you for it as well.

We will begin with you, Ms. Williams, and then I would just ask you all, because it is a large panel, to try and keep your remarks to about 5 minutes or so, so we can engage in the questions that all of us will have for you. And then any supporting documents or materials you would like for this Committee to have as part of this record, I will just ask unanimous consent that all documents that our witnesses provide be accepted as part of the record. Without objection, it is ordered.

Ms. Williams.

STATEMENT OF JULIE L. WILLIAMS, FIRST SENIOR DEPUTY COMPTROLLER AND CHIEF COUNSEL, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Ms. WILLIAMS. Thank you. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, my name is Julie Williams, and I am the Chief Counsel and First Senior Deputy Comptroller at the Office of the Comptroller of the Currency. The OCC appreciates the opportunity to testify today regarding the potential of covered bonds as a new funding mechanism for financial institutions and the issues presented in designing a covered-bond legislative framework.

Covered bonds are a promising funding option for financial institutions. They could serve as an alternative to securitization and

other current funding techniques and could be a new source of funds for lending and an alternative source of liquidity.

For the banking system, covered bonds could provide a funding source that is longer term and more stable and potentially less expensive than currently available alternatives. The structure of covered bonds might require less collateral and may also accommodate a broader range of types of collateral than current options.

Covered bonds also may attract types of investors that would not otherwise invest in bank debt. Institutions also have a strong incentive to maintain prudent underwriting standards for loans in a covered-bond collateral pool because those loans remain on the institution's books.

That said, a complex combination of factors will determine the relative attraction of covered bonds compared to alternative funding sources. Because covered bonds remain on an institution's balance sheet, an institution must hold more capital than would typically be required if the assets were securitized. Thus, capital requirements could constrain the growth of covered bonds. And new accounting rules, upcoming changes in capital requirements, and the "skin in the game" provisions in the Dodd-Frank Act are all factors that could affect the relative advantages and disadvantages of covered bonds *versus* other funding alternatives.

The legal framework for covered bonds in the U.S. also will be a key factor in whether covered bonds flourish, and various legislative efforts have emerged recently to provide enhanced legal certainty regarding the elements of a covered-bond regime in the U.S.

My written testimony provides detail on the issues that we would suggest Congress consider in designing a legislative framework for covered bonds. We also offer some suggestions on how those issues could be addressed, and I will summarize those points.

First, what type of entity is eligible to issue covered bonds? We believe that limiting eligible issuers to entities already subject to Federal supervision will ensure that dedicated financial supervisors can monitor and control the growth of covered-bond programs, react to emerging issues, and promote safe and sound programs in the institutions they supervise.

Second, what agency or agencies are appropriate to regulate U.S. issuers and programs? We support a framework where Federal financial regulators operating under a single uniform set of standards would be designated as the covered-bond regulators for their respective regulated entities.

Third, what types of assets should be eligible to collateralize the covered bonds? We suggest that a new covered-bond program start with a relatively conservative scope, with regulators authorized to expand the eligible asset classes as more experience is gained with covered-bond programs.

Fourth, what specific standards should be applicable to covered bonds and covered-bond issuers? These could include, for example, minimum eligibility criteria by asset class, limits on size of issuances, and overcollateralization standards. Here legislation could provide direction on key issues and charge regulators with adopting the detailed standards to implement those directions.

Fifth, what are the consequences of a default of a covered-bond issuance or the failure of a covered-bond issuer? How a U.S. legal

framework resolves how a covered pool is treated in the event of a default or insolvency of a covered-bond issuer and the role of the FDIC will critically affect the appeal of covered bonds to investors.

And, last, what reporting and securities standards should apply to covered bonds? We support transparency and availability of information to investors as important components of a comprehensive covered-bond regime.

I appreciate the opportunity to appear today to discuss these issues. I would be happy to answer any questions. Thank you.

Senator REED [presiding]. Thank you, Ms. Williams.

Mr. Krimminger, please.

STATEMENT OF MICHAEL H. KRIMMINGER, DEPUTY TO THE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. KRIMMINGER. Good morning, Chairman Dodd and Members of the Committee. On behalf of the FDIC, I want to thank you for the opportunity to testify about covered bonds. I am Deputy for Policy to Chairman Bair and have had the privilege to work on many of the issues that we will discuss this morning.

Early on, the FDIC recognized covered bonds as a potential source of bank liquidity, but one that should be balanced within the U.S. financial system. To do this, in 2006, the FDIC worked to clarify our policies with the first U.S. banks to issue covered bonds. Later, in mid-2008, the FDIC adopted a Covered Bond Statement of Policy to further solidify that foundation.

However, the intervening financial crisis has prevented new covered bonds so far. While there is some question whether a legislative framework is essential, the FDIC does support balanced legislation. We believe legislation should embody three key principles.

First, it should clarify the rights and responsibilities of investors, issuers, and regulators.

Second, it should not transfer investment risk from covered-bond investors to the public or to the Deposit Insurance Fund.

And third, it should be consistent with longstanding U.S. law and policy for secured creditors. In short, covered-bond investors should not be given rights that are unavailable to any other investors.

My written statement provides a detailed explanation of these principles. I will concentrate today on the need to provide protections for the Deposit Insurance Fund and to preserve the priorities of U.S. laws.

We have worked with the sponsors of H.R. 5823, the United States Covered Bond Act of 2010, and appreciate the evolution of that legislation to address some of our concerns. However, a few key concerns remain. Of course, we will continue to work with the sponsors and other members to address these continuing concerns with that legislation.

I think the importance of the Deposit Insurance Fund to stability in our banking system is very apparent today. Key statutory protections for this Fund are, one, the FDIC's ability, or duty, I should say, to use the least costly way to resolve banks, and two, the ability to fulfill this duty by getting the best value for a failed bank's assets, such as a covered-bond program.

To maintain these protections, we urge that any covered-bond legislation preserve the FDIC's flexibility in handling covered bonds in receiverships. Today, the FDIC has three options. First, it can continue to perform under the covered bonds and then sell the program intact to another bank. Second, the FDIC can turn over the collateral to the investors. Finally, the FDIC can terminate the program, pay the full value of the bonds plus interest, and reclaim the cover pool. This flexibility is critical to protect the Deposit Insurance Fund. It allows the FDIC to effectuate the least costly resolution for a failed bank by recovering the best value for its assets, as we did when Washington Mutual failed and we sold the program to JPMorgan Chase.

Unfortunately, in our view, H.R. 5823 gives the FDIC only two options, transfer a covered-bond program in a certain period of time or turn over the collateral to the investors. In effect, it transfers the risk of loss to the Deposit Insurance Fund if, as is usually the case, the cover pool is worth far more than the total due on the bonds.

H.R. 5823 gives investors rights that no other creditors get under U.S. law, whether in bankruptcy or in FDIC receiverships. Under the House bill, investors get to keep all the cover pool, even if the full par value of their bonds plus interest is far less, which is usually the case. All the Deposit Insurance Fund would get is a, quote, "residual certificate" for any remaining value left after 10 or 20 years. Unfortunately, the certificate is likely worth nothing.

Longstanding U.S. law properly says a secured creditor, like the covered-bond investors, has a claim to keep the collateral only up to the amount due on the debt. H.R. 5823 turns this on its head and makes the Deposit Insurance Fund bear the lost value of the collateral that exceeds the total due on the bonds. In effect, the proposed bill would give the covered-bond investors a superpriority over the Deposit Insurance Fund.

I want to be clear. Contrary to what some argue, the FDIC is not trying to pay only the market value of the bonds, which, as we saw during the fall of 2008, can be dramatically discounted. The FDIC will support legislation that guarantees the investors the bond's par value plus accrued interest if we cannot sell the program and must terminate it. This gives the investor full value while preserving the FDIC's existing power to recapture the excess collateral value on behalf of the fund and the depositors. So long as investors are paid the full principal amount of the covered bonds and interest to the date of payment, there is no policy reason to protect them beyond that, especially through an indirect subsidy from the Deposit Insurance Fund.

In effect, the super-priority could create a new class of investments that appear to be risk-free and can lead to a mispricing of the risk of covered bonds. As we have seen, mispricing of risk can have disastrous consequences.

As I said before, the FDIC supports a vibrant covered-bond market in the U.S. and will continue to work with Congress, other regulators, and the industry to create one. Thank you again for the opportunity to testify.

Chairman DODD [presiding]. Thank you very, very much. I appreciate it very much.

Mr. Stengel, welcome.

STATEMENT OF SCOTT A. STENGEL, PARTNER, ORRICK, HERRINGTON AND SUTCLIFFE LLP, ON BEHALF OF THE U.S. COVERED BOND COUNCIL, SECURITIES INDUSTRY, AND FINANCIAL MARKETS ASSOCIATION

Mr. STENGEL. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am grateful for your invitation to testify today on the crucial role that U.S. covered bonds can play in stabilizing our financial system and contributing to our economic recovery.

I am a partner with Orrick, Herrington and Sutcliffe and a member of the Steering Committee for the U.S. Covered Bond Council. The Council is comprised of investors, issuers, dealers, and other participants in the covered-bond market and we strive to develop policies and practices that harmonize the views of these different constituencies and that promote a vibrant market for U.S. covered bonds.

The precarious state of our Nation's economy has become all too apparent. Almost 17 percent of Americans are still unemployed or underemployed. More than half of small business owners are experiencing cash-flow issues. Nearly one out of four homeowners is underwater on a mortgage, and a record percentage of commercial mortgage loans is delinquent.

In the Council's view, sustained economic growth begins with a stable financial system. While the Dodd-Frank Act has supplied some important structural elements, there is still a need for long-term and cost-effective funding that is sourced from diverse parts of the private sector capital markets and that can be translated into meaningful credit for households, small businesses, and the public sector. We believe that covered bonds are an untapped but proven resource that could be invaluable in meeting this need. We also believe that the time for U.S. covered bonds is now.

At its core, a covered bond is simply a form of high-grade debt that is issued by a bank or other regulated institution and that is secured by a dynamic cover pool of financial assets. What distinguishes covered bonds from other secured debt is a legal framework for managing and maximizing the value of the cover pool after the issuer's default or insolvency, and only if the cover pool is adequate, continuing scheduled payments on the covered bonds. Over the course of their 240-year history, covered bonds have been backed by a wide array of asset classes that benefit from long-term, stable liquidity and that are significant to national economies.

U.S. covered bonds can stabilize our financial system and encourage economic growth in several ways. First, with maturities that extend out to 10 years or more, covered bonds can infuse longer-term liquidity into the credit markets as a complement to the shorter-term funding that is supplied through the Federal Home Loan Banks and the securitization and repo markets.

Second, by providing more cost-effective liquidity for lenders, covered bonds can produce less expensive and more available credit for consumers, small businesses, and the public sector.

Third, covered bonds can add funding from a separate investor base that would not otherwise make this liquidity available through the unsecured debt or securitization markets.

Fourth, covered bonds can deliver funding from the private sector even in distressed market conditions without any explicit or implicit Government guarantee or other taxpayer support.

Fifth, because issuers continue to own the assets in their cover pools and have 100 percent skin in the game, incentives relating to loan underwriting, performance, and modifications are strongly aligned.

And sixth, as a straightforward financial instrument, covered bonds can increase transparency and uniformity in the capital markets.

To function successfully, however, a U.S. covered-bond market must be deep and highly liquid, and that requires the kind of legal certainty that only legislation can provide. Covered bonds developed in Europe under dedicated legislative frameworks and this precedent, now found in almost 30 other countries, has set expectations. The twin pillars of such a framework are, one, public supervision by a covered-bond regulator that can protect the interests of investors, free of any conflict, perhaps like the FDIC's duty to the Deposit Insurance Fund, and two, a separate resolution process that is clear and unequivocal and that is designed to avoid forced acceleration of covered bonds and a fire sale of the cover pool after the issuer's default or insolvency. These pillars, which afford the legal certainty required for investors to dedicate funds to this market, cannot be replicated by regulatory action like the FDIC's Covered Bond Policy Statement.

Without action by Congress, European and other non-U.S. issuers will be left to fill the void. Thus far in 2010, they have targeted over today $19 billion in U.S. dollar covered bonds to investors of the United States. The result is an increasingly uneven playing field for U.S. institutions of all sizes and less available credit for families, small businesses, and the public sector.

The Council, therefore, fully supports covered-bond legislation of the kind offered during the House–Senate Conference on the Dodd-Frank Act, and I want to thank Senator Corker and Congressman Garrett for their leadership and Chairman Dodd for holding this hearing. I would be pleased to answer any questions that Members of the Committee may have.

Chairman DODD. Thank you very, very much.

Professor, Snowden, thank you.

STATEMENT OF KENNETH A. SNOWDEN, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF NORTH CAROLINA AT GREENSBORO

Mr. SNOWDEN. Chairman Dodd and Members of the Committee, I appreciate the opportunity to testify today before the Committee concerning potential uses and regulation of covered bonds in the U.S. mortgage market. I am an economic historian who for the past two decades has studied the development of the U.S. mortgage market. The purpose of my testimony is to share with you some of the research I and others have done concerning the history of the

market and the role that covered mortgage bonds have played within it.

Really, one of the motivations we hear for using covered bonds is what I will talk about mostly today, which is that they are very popular and have a record of success in Europe. In fact, the European record of covered mortgage bond success stretches back over 200 years.

My own research is completely U.S.-centric, but I became aware of the history of covered bond use in Europe two decades ago when I came across commentaries by late 19th century writers in the United States that complained bitterly about the absence of covered bonds in this country. These comments provided evidence that market participants in the U.S. were well aware of covered mortgage bonds as early as 1870, and this led me to question why the mechanism hadn't been implemented here.

Further exploration revealed, in fact, that they had been introduced several times between 1870 and 1935. So at that point, the important question became, why did covered bonds not become a permanent fixture in the U.S. mortgage market after being introduced? My testimony briefly surveys the record to provide the Committee with this historical perspective as you consider legislation to encourage the introduction of covered mortgage bonds one more time.

I divide the historical record into two parts. The first lies between 1870 and 1900, when covered mortgage bonds were introduced in the U.S. without the regulatory framework that was used at that time in Europe. The covered mortgage bond had its greatest success during this period in the Western farm mortgage market with companies that normally brokered whole mortgage loans to investors, but they began to issue bonds secured by mortgages instead of selling the loans outright.

I have examined one of these companies in depth and found that the loans it placed behind its covered bonds were, in fact, riskier than the ones that it brokered. That result appears to contradict the generalization that underwriting standards are strict inside a covered mortgage bond structure. But in this case, the issuer could shift risk between brokerage and covered bonds because of ineffective regulation.

A more obvious lesson can be drawn by the way these companies failed during the general farm mortgage crisis of the 1890s. Serious malfeasance occurred throughout the covered mortgage bond sector during the crisis because there was no regulation in place to control the behavior of the mortgage companies after their financial capital had dissipated. These failures affected the reputation of covered mortgage bonds in the United States for decades.

The Federal Government takes center stage in the history of covered mortgage bonds between 1900 and 1935. Your predecessors in the 63rd and 64th Congresses benefited from an extensive investigation of covered-bond systems in Europe before they created the Federal Farm Loan Bank System in 1916. The system was comprised of both public and private institutions and both relied on covered mortgage bonds as their financing.

The privately financed Joint Stock Land Bank component of this system was structured and regulated just like institutions in Ger-

many, and this led private farm mortgage companies in the United States to oppose and avoid the system because of restrictions on their activities that were placed by these German practices.

Twenty years later, the 73rd Congress authorized the creation of a privately financed, federally regulated covered residential mortgage bond program to provide a liquid market for the new FHA insured mortgage loans. No private institution was ever chartered under this authority, and the discussion about introducing covered mortgage bonds to the U.S. went silent for decades.

In the final section of my testimony, I provide an overview of the development of the institutional residential mortgage market over the past century to provide perspective on how the introduction of covered mortgage bonds at this time fits into its long-run pattern of development.

I will close my remarks, however, by summarizing two lessons that I draw from the historical record. First, past failures of covered mortgage bonds in the U.S. are explained by a combination of bad timing, poor implementation, and ineffective regulation. We need to do a better job of incorporating covered bonds into the U.S. mortgage market rather than to abandon the effort.

Second, a common failure in past attempts was to transplant elements of a European covered mortgage bond system without tailoring them to fit U.S. institutions. We need to identify features of the U.S. mortgage market that could be incompatible with European covered mortgage bond practice while, rather than after, regulation is being formulated.

I thank you for your time and would be happy to answer questions.

Chairman DODD. Thank you very much, Professor.

Mr. Campo, good to have you with us this morning.

STATEMENT OF RIC CAMPO, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CAMDEN PROPERTY TRUST, ON BEHALF OF NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

Mr. CAMPO. Thank you, Chairman Dodd and distinguished Members of the Committee. I am Ric Campo, Chairman and CEO of Camden Property Trust, a publicly traded apartment firm. I am the Immediate Past Chairman of the National Multi Housing Council and I am testifying today on behalf of NMHC and our joint legislative partner, the National Apartment Association.

We applaud the Senate Banking Committee for exploring alternative sources of capital to support housing. We believe covered bonds could indeed provide some degree of additional liquidity to the U.S. multifamily finance. We caution, however, that it is quite unlikely that covered bonds could provide the capacity, flexibility, or price superiority necessary to adequately replace any of the U.S. traditional sources of multifamily mortgage credit. I am hoping to provide you with the apartment sector's perspective based on our general credit needs and to share some insights into what role covered bonds could play in meeting those needs.

One-third of American households rent. About 16.7 million households live in rental apartments. Our industry depends on a reliable source and sufficient capital to meet the Nation's rental

housing demand. Currently, private mortgage lenders have left the market, forcing us to rely heavily on credit insured or guaranteed by the Federal Government, namely FHA, Fannie Mae, and Freddie Mac. Eighty percent of the apartment loans that were issued in the first 6 months of 2010 have some form of Government credit behind them. Therefore, our concerns are over the broader issue of housing finance reform and the unintended consequences that could reduce credit now provided by the GSEs.

Since the conservatorship, the latest data shows that Freddie Mac's multifamily unit has generated a billion dollars of profits that have been used to offset the losses on their single-family book. Fannie Mae's numbers are similar. This is a strong indicator that the model for the multifamily finance market works pretty well.

We support a careful look at covered bonds as a supplemental source of credit. The European experience indicates that covered bonds provide numerous benefits to issuers and investors. Investors earn attractive risk-adjusted yields on low-risk diversified securities. Financial institutions that issue the bonds benefit from the lower cost of funds and reduced risk-based capital requirements along with meaningful collateral substitution capabilities.

For numerous reasons, though, it is quite unlikely that covered bonds could provide the capacity, flexibility, and pricing superiority necessary to adequately replace the U.S. existing sources of multifamily credit. First, it is unclear whether covered bonds would actually increase the amount of credit banks would make available to apartment firms because the covered-bond structure limits the issuers' lending volumes by requiring them to hold loans on their balance sheet and retain capital reserves in case of losses. It is also possible that banks could simply replace some of the home loan activities with covered bonds, which would not increase lending capacity. Even then, however, larger banks are anticipated to be more—major covered-bond issuers may choose not to issue covered bonds for multifamily mortgages because they already originate such mortgages for the GSE and CMBS market and avoid any balance sheet liability. Additionally, since so many asset classes qualify for covered bonds, it is unclear whether the banks would use them to increase multifamily lending.

It is also important to understand that the European experience with covered bonds for multifamily properties may not be transferrable to the U.S. In Europe, the rental markets operate on a condominium model comprised of small investors buying individual units and renting them out. For instance, in the U.K., 73 percent of the rental stock is owned by mom-and-pop operators and there is no institution investors.

Likewise, questions remain about whether a purely private American covered-bond market could be a critical backstop capital during the periods of financial instability. Europe's covered-bond market came to a standstill during the global financial crisis, going dormant for several months after Lehman Brothers collapsed. Some European jurisdictions have still seen no issuance. In contrast, in the U.S., Fannie Mae and Freddie Mac continued to provide liquidity to the multifamily sector at a profit.

For all these reasons, we can only conclude that the covered-bond market might augment but not adequately replace any of the com-

ponents of the U.S. multifamily finance. Apartments are a critical component of our Nation's housing market and the apartment industry depends on the reliable, reasonably priced, and readily available supply of credit to meet the Nation's growing demand for rental housing. We look forward to the return of credit liquidity from all sources, including covered bonds, and welcome your efforts to increase the credit liquidity in the future.

Thank you, and I look forward to your questions.

Chairman DODD. Thank you very, very much. We appreciate your testimony, as well, and all of you this morning, and I will ask the Clerk to kind of keep an eye on the timing here so we don't go over too long. There are only three or four of us here. Senator Merkley has joined us, as well. I will begin with a few questions, and then I will turn to Senator Corker and we will go back and forth here this morning. But I thank all of you again for your participation this morning.

Let me begin, if I can, Mr. Krimminger and Ms. Williams, your testimony suggested covered-bond programs as now proposed could create the impression of implied guarantees by Federal bank regulators. One, do you agree this could be the case, and I think you implicitly have suggested that, and if so, then how can this be prevented?

Ms. WILLIAMS. Mr. Chairman, the point that we noted in our testimony was that the selection of a single covered-bond regulator, and depending upon what entity that single covered-bond regulator would be, an existing agency or even if one new one were created, might incrementally enhance an impression that there was a Government backing of the financial performance of the bond itself as compared with the impression that one would take if the Federal financial regulators were the covered-bond regulators for the respective institutions that they supervise. So that would sort of put the covered-bond regulator role more in the framework of oversight supervision of adherence to standards that the financial regulators adopt and then implement and apply as opposed to having a single agency viewed as the covered-bond regulator.

Mr. KRIMMINGER. I would certainly agree with Ms. Williams that I think there are three key factors from our view that could give that kind of implied, if you will, view of Government support. One is we certainly support the idea that there could be or should be standards being set, particularly by the Federal banking regulators or the Federal Financial Institutions Examination Council, which combines all the regulators. But to have direct oversight specifically for the purpose of protecting the investors' interests *versus* the safety and soundness of the financial institutions certainly creates another level, if you will, of Federal involvement in the program.

Chairman DODD. Would that be unique? Would that create a unique category, then?

Mr. KRIMMINGER. It would create, from our view, a unique category in the United States certainly, and it is very common in Europe. You have, for example, in the European Pfandbriefe example, the BaFin, which is the primary regulator in Germany for banks, does have the responsibility by law to provide specific oversight for covered bonds for the benefit of investors. I think that creates a

conflict and creates certainly an implication of there being some support.

The third part of that is in the resolution of covered-bond defaults, or defaults by issuers. Under the proposed regulation or the proposed legislation, the regulator would then be responsible for perhaps removing a trustee that would be used over the separate estate. So you have an estate leaping out, if you will, of the failed institution, the failed bank, depriving the banker receivership of collateral that benefits the Deposit Insurance Fund and other creditors. But, also the trustee could be removed by the regulator based upon the interest of the investors. That provides a level of oversight of the insolvency process for the private investors' benefit that would be somewhat unique under U.S. law.

I think one last point I would make is that there are very great differences between the U.S. system and the European system. In many cases in Europe, part of the support for covered bonds has been the fact that banks that issue covered bonds are simply not closed, and certainly that is not consistent with the intent of the Federal Deposit Insurance Act and certainly the intent of the Dodd-Frank Act, that is certainly not an avenue we wish to go down.

Chairman DODD. No, that was one area there was pretty significant agreement, I think.

[Laughter.]

Chairman DODD. Let me give Mr. Stengel a chance to respond to that, but let me ask you a question, if I can, Mr. Stengel, and then give you the opportunity to respond to what has been raised here. The FDIC in its testimony here this morning, and I am quoting them here, said any covered-bond legislation must preserve the flexibility that current law provides to the FDIC in resolving failed banks, including the options of continuing to perform under the covered-bond program pending a sale to another bank, turnover of collateral to the investors, and repudiation. It was on page seven of the testimony.

The Covered Bond Council testified that having all of these alternatives raises uncertainty for investors, and I think it is a legitimate point. But should the FDIC have this flexibility or should investors of covered bonds have greater certainty and the choice here? And again, obviously, given the history of the FDIC and how important that has been for avoiding the kind of problems that created the FDIC in the first place here, what about what would happen in the event of a failure of a bank that issued covered bonds, where you might have that certainty if you would take the Council's point of view, but lack the flexibility that the FDIC would need. How do you answer that?

Mr. STENGEL. Well, I think in a couple of ways. First, it is certainly not unprecedented. I mean, looking at just some rough data, the top—looking at the top 50 banks alone, they have over $1 trillion of assets pledged either under securities lending or repos, and that represents over approximately 10 percent of their assets. Now, these lenders have much more enhanced rights than anything in the proposal from the U.S. Covered Bond Council.

So I think the notion that there is a dichotomy between secured creditors and unsecured creditors and there is uniformity among

secured creditors is not entirely accurate, that there are, in fact, quite a few secured creditors with quite a lot of flexibility, and particularly those with these qualified financial contracts, repos, and securities loans, not to mention the Federal Home Loan Banks. So the notion that today the FDIC has unlimited flexibility, I think is just not entirely accurate.

In response to the notion about the regulator, I think certainly the Council understands the perspectives of the regulators and the concern about having a single covered-bond regulator. Our primary concern is a fragmentation of the market. So, for instance, if you were to have each individual regulator able to write separate rules of the road for covered bonds, that would create a fragmented market that we don't think would be quite helpful.

I think we could be supportive and would support, for instance, the Department of the Treasury writing the rules of the road and then having those implemented by the individual prudential regulators. That is something that seems to be a compromise that makes a lot of sense.

Chairman DODD. Do either of you other two want to comment on this exchange, Mr. Snowden or Mr. Campo? No?

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I thank all of you for your testimony.

It seems to me the essence of the rub on covered bonds and all of these other things that we have talked about can be worked out pretty easily, but the essence is going to be the rub between the FDIC and everybody else. I mean, they have the ability to do whatever they wish when they resolve an institution today, and obviously a covered bond potentially eats into that flexibility. So it seems that to create a regimen that is going to work, that is the issue that has got to be—that is the rub. That is the essence of this entire deal.

I will ask a couple of questions of you, Mike, but when we have risk-weighted sort of assessments now of institutions and if institutions are involved in covered bonds, couldn't you—doesn't that actually enable the DIF to be stronger when you make those assessments? I mean, isn't that something that, on one hand, is a plus as it relates to the DIF itself?

Mr. KRIMMINGER. Well, certainly, Senator. The fact that now the assessment process is essentially assets minus net equity does allow us, does allow, for example, covered bonds, since they are on the balance sheet, to be part of the assessment base, whereas they weren't. I think the problem, however, is that the assessments would need to be extraordinarily high on assets if they were to cover against the loss of our ability to recapture the overcollateralization.

And if I might just give one illustration, when Washington Mutual failed in the fall of 2008, they had one of the two covered-bond programs that were outstanding. At the time that they failed, the overcollateralization requirement by the rating agencies in the industry, if you will, to try to maintain a AAA rating, which they weren't able to maintain, was 149-plus percent. So that is a huge amount of overcollateralization.

I think all the flexibility we are seeking would simply be that we would pay—and this is different from our original statement of policy, and I want to make sure that people understand that—we would be, under legislation be willing to certainly make sure that covered-bond investors were covered to the full par value of their bonds plus accrued interest through the date of payment so that there would be—that would be the full amount of debt they could ever claim. And I think that provides the benefit that a covered-bond investor would be entitled to. It would give a pool of cash that could be then either reinvested by a trustee or through a guaranteed investment contract or something to pay the cash over the long term, which is what the investors are looking for.

And if I might comment on the unprecedented nature of what would be done for covered-bond investors, I think an important thing here is that Mr. Stengel mentions the qualified financial contracts. As I noted in one of the footnotes in my testimony, there is some additional protection provided for qualified financial contracts, but even for those contracts, you are limited to the amount of your collateral protection by the amount of the actual debt due at the time the bank fails, and that is all we are seeking here, as well. Covered bonds simply are not QFCs.

Senator CORKER. So, Mr. Stengel, does the solution that Mr. Krimminger has offered, is that something that would create a viable covered-bond market?

Mr. STENGEL. We could certainly build a covered-bond program if covered bonds were treated like qualified financial contracts. So if the concept is we would like to use existing precedent that qualified financial contracts or something that are known in the United States, and the FDIC feels like the remedies there are more consistent with something that they are familiar with and would agree to, I think that that could very easily be done.

I think the counterparties under qualified financial contracts like repos and securities loans have a number of enhanced rights which we did not initially recommend because of our intent to try to accommodate concerns that we expected from the FDIC. They have a higher claim for damages, in fact, that includes the costs of cover, which covers the reinvestment risk which covered-bond investors are very concerned about. So that would be covered under the QFC structure. They have a right to take more rapid remedies. So within 1 day, if the entire covered-bond program, and, in fact, all covered-bond programs of an issuer were not moved to another bank, in 1 day, the investors could come in and take their collateral. They have immunity from nearly all avoidance actions. And there are limits on the FDIC's ability to repudiate the contracts and transfer them. Again, they all have to go or none of them go.

So I think if we were to use a QFC structure, the Covered Bond Council could be very supportive of that kind of approach, and if that is what is being proposed here, I think that we probably have a lot of middle ground to cover.

Senator CORKER. Since it is, in essence, a debate between the two of you, and I notice he disagrees, go ahead.

Mr. KRIMMINGER. That, as the Senator knows, that is not what we were proposing. I was just making the point that even under the QFCs, your value is limited to the amount of your debt. Yes,

there is a cost recovered, but you don't get to keep your collateral for the balance of your contract.

Senator CORKER. When you were moving, say, an institution fails and you move the covered bond off to another institution, can't the FDIC sell that overcollateralization and reap some benefit from that? So it is not like—it is not quite like you said. I mean, you have a benefit there, too, do you not?

Mr. KRIMMINGER. Well, that is one of the three options that we talked about. Certainly, one of the options and the preferred option—we have made this very clear in our statement of policy, as well—is to transfer the covered-bond program over to another bank, which is what we did with the WaMu covered-bond program. There, it is part of the assets and we are getting the benefit of the franchise value of that program as a liquidity tool back to the Deposit Insurance Fund.

The reason we need the repudiation power is that in those cases where we cannot transfer it, there is no interest in that particular program and it is heavily overcollateralized. We think that the Deposit Insurance Fund and the creditors should get the overcollateralization, not the investors. The investors should get paid in full, but not overpaid.

Senator CORKER. Mr. Chairman, my time is up. I know we have had debates in our conference rooms between the FDIC and others and we look forward to having the two of you in soon, so thank you.

[Laughter.]

Mr. KRIMMINGER. Thank you, Senator.

Chairman DODD. Thank you very much.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

I want to follow up the thoughtful questioning of the Chairman and Senator Corker and just clarify in my mind a couple of points. One, if there was a covered-bond program, that would require, since these assets are on the balance sheets, higher capital? Would that be a general point?

Ms. WILLIAMS. The basic point is that there would be a capital requirement that would apply——

Senator REED. Right.

Ms. WILLIAMS. ——because it is on balance sheet.

Senator REED. Right.

Ms. WILLIAMS. Yes.

Senator REED. And in contrast to selling the mortgages in the secondary market where that would——

Ms. WILLIAMS. In contrast——

Senator REED. ——a *bona fide* real sale——

Ms. WILLIAMS. Yes, in contrast to a sale of the mortgages that would be treated under the accounting standards as a sale.

Senator REED. So one of the things if we pursue a covered-bond program would be there would be a conscious decision the institution would have to make between doing covered bonds and likely having higher capital. That is——

Ms. WILLIAMS. That is definitely a factor that affects the attractiveness for any given issuer.

Senator REED. And then with respect to the FDIC, is the implication in your testimony that there would be a higher assessment be-

cause of the—if the rules were changed, in effect, that you would fully protect the covered bondholder in a failed institution, that would require a higher assessment?

Mr. KRIMMINGER. I think it no doubt would. We are currently obviously looking at our assessment structure and the risk-based assessments generally because of the change to the assessment base. But certainly if the flexibility were taken away, we would need to seriously look at much higher assessments for those who issue covered bonds.

Senator REED. So if the covered-bond program was authorized in the broadest framework, as the proponents suggest, two likely consequences for financial institutions would be maintaining higher capital, which in effect probably limits their ability to provide more liquidity in the marketplace, and higher assessments. So it is not a completely win–win for the economy, is that fair?

Ms. WILLIAMS. I think it is absolutely fair to say that there are advantages and disadvantages of covered bonds relative to other funding options.

Senator REED. And let me just again, to the point I sense you are making, is that in a failed institution, the FDIC is obligated to pay not just the par value plus accrued interest, but all of the interest and par value of the bond, that in some respects could be described as a subsidy by the Government to those bondholders that is not extended to other parties. Is that——

Mr. KRIMMINGER. Our view certainly, Senator, is that that would be—it would be certainly creating a subsidy for the covered bonds by the Deposit Insurance Fund, because otherwise that overcollateralization would come to the Deposit Insurance Fund now.

Senator REED. Right. Right. And so in some respects, and Mr. Stengel, and I want everyone else to comment, too, there is the issue of uncertainty, but there is the issue of is there a disguised subsidy here also because of preferential rules in the failed institution. Is that one reason now that these aren't as attractive or as used as they could be?

Mr. STENGEL. I would not characterize the covered-bond programs that at least the Council has proposed as involving any Government subsidy of any kind. It is probably important to remember that it is the banks, after all, that fund the Deposit Insurance Fund. In fact, the top four banks account for approximately 40 percent of the Deposit Insurance Fund, so if there are stakeholders here, certainly I think the disadvantages, and the banks are aware that it involves higher capital and it also involves perhaps higher deposit insurance assessments. The FDIC before the Dodd-Frank Act had come out with a particular secured liability assessment to penalize banks for engaging in secured lending from an insurance assessment standpoint.

So I think that there is a recognition that there are costs and benefits. I think the message that we want to convey is that if we are talking about covered bonds that can be accelerated, we are not talking about covered bonds and we can put our pencils down and there will be no market. And so there certainly is a different treatment for covered bonds than normal secured debt. It is not as aggressive as the QFCs. It is certainly not as aggressive as the Fed-

eral Home Loan Banks. So it was something that we thought struck a reasonable middle ground in order to get the market and introduce it into the United States. But without those, there will be no market.

Senator REED. Well, let me just shift briefly, because one of the comparisons we have is with the Europeans who use these, and Professor, you have pointed out that in 1916, our predecessors—I don't think anyone is here from that Congress, but who knows——

[Laughter.]

Senator REED. The Europeans, though, particularly, and I will express my ignorance, use very short-term nonrecourse mortgages for residential mortgages. Is there a difference between the types of mortgages that they are doing this routinely with that makes a difference? Maybe you might comment, Professor.

Mr. SNOWDEN. I would be happy to. Again, I am not an expert on contemporary European practice. Actually, in the farm mortgage market, one of the great advantages of covered bonds there were very long-term amortized loans, mortgage loans, at a time in the United States where farmers had to rely on 3- to 5-year debt, rollover, and this is why farmers wanted a covered-bond program. This is why you guys passed it—I mean, not you, your predecessors. Excuse me.

[Laughter.]

Senator REED. Yes. We have established they are not here.

[Laughter.]

Mr. SNOWDEN. Right. But if I could point out that one of the characteristics of these early covered-bond programs in Europe were they were monoline. This was their job. This was all they did. And I think as you think about these issues of insured institutions taking on this product line, one way of thinking about the subsidy, to me, is what would this business look like if it stood alone, and especially, I think, it makes you look at the dynamic pool aspect.

People complain about securitization. One thing about securitization that is good is once you stick the loans in there, no matter how they perform, they stay there. In a dynamic pool, you are going to have—if there are any problems in that pool, those loans have to be pulled out. Now, this is what my guy did in Kansas in the 1880s. He was able to put them behind his covered bonds because there was no regulation of covered bonds and he bilked people this way.

I think the concern—we are not in that situation today, obviously, but if there is any difference between underwriting standards in the covered-bond program and whoever else the deposit fund is supporting, there is going to be shifting of risk between those programs.

The other thing is, when you talk about subsidy, if these were stand-alone businesses, these covered bonds, who would cure the bad loans? And that would have to be a cost of business.

I will just bring up this last point, and a difference with Europe is at least in my time period, foreclosure was very rapid in Europe. These mortgage banks could take over foreclosed land in 15 days in some cases, which means not only could they cure defaults very rapidly, they were expected to. In the United States today, we have a problem where foreclosure is a long process, apart from the

securitization problem. I mean, I understand that. But just the fact of doing it. So you are going to have default pools sitting there. Where will they sit? Who will fund those default pools, because they have to be pulled out from behind the secured bonds.

Senator REED. Thank you. My colleagues have been very gracious. Just one other point, and I will make it and if you have to correct me, please correct me. I have been told basically, too, that in most mortgage arrangements in Europe, there is personal liability, as well, so that you can't just sort of walk away, they take the house and you are fine. They come after you. And that makes a difference in terms of what these types of pools will look like.

Thank you, Mr. Chairman. You are very kind.

Chairman DODD. Thank you very much, Senator.

Senator Merkley.

Senator MERKLEY. Thank you very much. There are many aspects of this strategy that are extremely appealing. One certainly is that rather than having a pool of securities to which the rights are sold to the cash-flow and then those bonds are remixed into a second waterfall and a third waterfall and so forth, but it makes it impossible, Professor, to know what they are buying, this is a much more direct transaction, potentially, and this is what I want to ask.

Would the structure be limited to a bank having a pool of loans, mortgages, and as you mentioned potentially other products, loan products, against which they are providing the collateral for essentially the loan to the bank, for the bond, or would banks be buying other bonds that they then use as collateral, and then would the bonds against those pools, would they be able to buy those so we end up with the same multilayered complexity that makes it impossible to understand the true nature of the collateral that we have in the mortgage market now?

Mr. STENGEL. At least under the Council's proposal, it would be a single eligible asset class, which would be loans, backing a single issuance of covered bonds, so something much more straightforward. There would be the opportunity to invest proceeds in Treasuries and other what we call substitute assets, which are really cash equivalents. But the notion of the CDO-squared or cubed is not something that we are looking for.

Senator MERKLEY. I am very glad to hear that. Another challenge we had was with rating agencies not having access to all the details of the specific loans themselves. Is it envisioned under this proposal that a rating agency would be involved to help establish to investors the quality of the underlying collateral, and would they have access to all the loan-level detail?

Mr. STENGEL. It is expected that covered bonds would receive a rating, assuming we still have that process going on in the wake of the Dodd-Frank Act. And so certainly as part of that process, rating agencies would have access to whatever they felt was required in order to provide the rating.

On that point, I think it is worth noting, none of these programs have a trip wire on the rating. So the notion that they have to keep putting in good assets to maintain a rating which is a covenant in the documents is not required. The rating agencies will provide their rating and certainly, as the regulators have done in the past

using their existing cease-and-desist authority, and certainly all the new powers under the Dodd-Frank Act, have more than enough power to say, you are not going to put any more assets into the cover pool just to maintain a rating. So the rating agencies will be involved, and I think there are a lot of protections to make sure that that process does not go off the tracks.

Senator MERKLEY. If we turn the clock back just a little bit, the pools that were utilized in the CDOs and CDO-squared, there was also a right to substitute failing bonds, and there was a—an account manager had a responsibility to do that. For some reason, that really didn't unfold in a manner that sustained the value of those pools and it all collapsed and I never really quite caught what went wrong in that substitution process.

Mr. STENGEL. In the case of CDOs, it really was—to some degree, they worked in the sense that they transferred the risk of the underlying assets to the investors. I think the issue was there were no good assets to bring in and substitute because the CDOs weren't set up to actually have an originator like a bank that makes loans and can put new assets into a pool, much like you think of any commercial lending with a borrowing base and that there is a revolving inventory of assets coming in and out. So CDOs weren't set up that way. So while there was a possibility of going out and bringing in new assets, ultimately, you were limited to the proceeds of what you had available to begin with and those just turned out to be very risky and for a lot of loss.

Senator MERKLEY. So let me turn to another piece of this. We have had a lot of discussion in this Committee about the situation where firms that originate securities should be limited, or people had various opinions, I had the opinion they should be limited in their ability to buy insurance that exceeds the value of the bonds they are issuing, in other words, gamble on the failure of the very products they are selling to the public. That was addressed in the Merkley-Levin Amendment.

Do you anticipate here that banks would be able to hedge their risk by purchasing insurance against the failure of the product, and if they were allowed to do that, would that be limited to the value of the product so that they are not actually gambling on the failure of what they are selling?

Mr. STENGEL. I think just a couple of points. You know, the Council, because of its unique composition, being equal investors, dealers, and issuers, we spent months having a very, very robust debate among ourselves, and we few lawyers who were allowed to tag along tried to proxy for regulators and the consumer, about how to create a benchmark covered-bond market. You know, there may be folks—there are a lot of smart folks out there and they may be able to come up with structured covered bonds and covered bonds that do all kinds of different things. But we wanted to propose legislation to the Members of Congress that would create a benchmark very safe and conservative market. So the kinds of things that certainly the Dodd-Frank Act was very focused on is not something at all that we are contemplating in the context of a covered-bond market.

Now, banks, I am sure, will hedge the assets on their balance sheet, their interest rate risk, their currency risk, according to pru-

dent risk management standards as dictated and informed by regulatory standards. But nothing of the kind that I think you are talking about is contemplated, at all.

Ms. WILLIAMS. Senator, if I could just add to that and reinforce the last point that Mr. Stengel made, the assets remain on the institution's balance sheet and so we will continue to have the concerns that we would have as a supervisor with respect to effective sound asset liability risk management.

Senator MERKLEY. I believe the—oh, please, go ahead.

Mr. KRIMMINGER. I am sorry to interrupt. I just wanted to make one comment on one point Mr. Stengel made just to make sure that it is clear. While there is not a trigger in the documents requiring it based upon rating agency action to replace delinquencies, there are contractual provisions that require replacement of delinquencies over a certain date so that this is a constantly refreshing pool. So there is constantly the requirement to put new loans in. So there is a benefit to the investors of having a quality pool throughout the time supporting a security for the general obligation of the bank, and our point really is that once the institution closes, no one is going to be adding to that pool. You are going to have a diminishing asset pool that is going to be of diminishing value.

We just believe that the investors should not get the benefit of a constantly refreshing pool but then be able to take all the collateral after a failure as you would with a securitization that is off balance sheet. They should get one or the other, but not both.

Senator MERKLEY. OK. Let me turn to a piece of the FDIC action in this regard, which is in 2008, a rule issued that limited covered bonds to, I think, 4 percent of the capitalization. Can you comment on that, because there is a concern that that type of limit would prevent development of a robust covered-bond market.

Mr. KRIMMINGER. That was a statement of policy that was issued by our board in July of 2008, and we had a 4-percent limit there in part based upon prior precedent of countries that had begun to introduce covered bonds, both in the United Kingdom and in Canada. In their early introduction of covered bonds, they had a 4-percent limit, as well. We were simply modeling on that with the expectation, which we stated up front in our board meeting as well as in the document, that we could limit as the market developed. We had talked with major issuers and they were of the view that 4 percent would be—was far in excess of their immediate plans to expand the programs they had as far as new issues, as well. So it was not going to be a constraint at the beginning of any type of covered-bond program. So we felt that that would be something that could be modified going forward.

Senator MERKLEY. I want to thank you all. I am way over my time. I thank the indulgence of the Chair, and I appreciate this discussion as we think about Fannie and Freddie and how we make home mortgages work in America. It is very helpful.

Chairman DODD. Thank you, Senator.

Let me ask a question and turn to Senator Corker for any questions he has. One, I would like to get Mr. Campo into this conversation a bit on the rental housing aspects of all of this, and he makes a very good point. One of the very legitimate complaints

over the years is that we have placed so much stock on home ownership, which has value in my view, and so very little increasing the stock of rental housing in the country that I think we contributed in no small measure to the problems we have been wrestling with over the last several years.

But I wonder if, Mr. Stengel, you might comment on Mr. Campo's testimony, his concern in the multifamily housing context, the problems posed by covered bonds.

Mr. STENGEL. I think Mr. Campo's point is very well taken in the sense that covered bonds will not replace securitization. Just looking at some quick figures, in 2006, the volume of securitization was $2.4 trillion—$2.4 trillion of issuance. Thus far in 2010, there is $0.4 trillion in issuance. And because securitization involves transferring these assets onto the balance sheets of investors, you are talking about $2 trillion—and this is just private label ABS and RMBS, so it doesn't include the agencies. So you are talking about $2 trillion of balance sheet that has been wiped away until the securitization market is resuscitated. So I think Mr. Campo's point there is very well taken, that covered bonds are no substitute. They are a complement, but no substitute for securitization.

I do think, at least based on the views expressed by the Council, that commercial mortgage, including multifamily covered bonds are something that are being actively looked at by potential issuers once the market gets up and running. Whether those are first out of the gate, I don't know, but I don't think they will be relegated to the sidelines at all. I think they will be center in the target of possible issuers.

Chairman DODD. I would encourage you to look at that and offer those ideas, because I think, and again, I am speaking for myself, but I think one of the things I feel strongly—I am looking at my own State of Connecticut where you have got to have an income of $20 an hour on average to afford a two-bedroom apartment, a rental unit. We have such a paucity of stock that obviously the supply and demand issues have driven up the cost tremendously, driving it out of the range of an awful lot of people who need that rental housing market to provide decent shelter for themselves. So to the extent we can increase the opportunity if the covered-bond market is going to be developed here that would allow for it to be used in the multihousing area would be important, it seems to me.

Mr. STENGEL. We completely agree, Senator.

Chairman DODD. And last, I wonder if you just might quickly, and maybe if you want, obviously, what the most important consideration the Committee should keep in mind in the issue of regulating covered bonds going forward. Why don't we begin with you, Ms. Williams. Tell me one or two things you think we ought to really keep in mind as we look at this.

Ms. WILLIAMS. I think that the conversation this morning has really highlighted the central issue. There is a tradeoff here with issues that are important to the FDIC. The set of issues that they have identified center on the differences between covered bonds and what we have now.

Chairman DODD. Yes.

Ms. WILLIAMS. And to the extent that you want to move to something new, you are implicitly raising issues about having something

different from the traditional way that the FDIC has viewed these situations. There is very much a balance for policy makers, a very interesting set of issues here to resolve.

What I hear the Covered Bond Council saying is that some of the features that are most critical to the success of having a robust covered-bond market in the United States are the very features that the FDIC has the concerns about changing.

Chairman DODD. Yes.

Mr. KRIMMINGER. I would just note that I think the key concerns are making sure that we don't create a super class of investments that can create mispriced risk and we should not transfer that risk on to the Deposit Insurance Fund in the case of a failure.

I would note also in response to one of the comments made earlier that although it has been stated, and I know this is the argument of the Council, that a covered-bond market cannot develop if the FDIC has the power to repudiate, I think there were certainly two very large programs that were developed before the financial crisis where that power still remained with the FDIC, and we are willing certainly to clarify these powers further. But I think it might be a bit of a misstatement to say that the market cannot develop. The financial crisis has sort of interrupted the markets here and in Europe.

Chairman DODD. Mr. Stengel.

Mr. STENGEL. Mike is a friend, and we have known each other a long time. And I grew up in my early years as a bankruptcy lawyer, so I, more than most, am sympathetic to the FDIC's concerns and appreciate them. The netherworld of receivership and bankruptcy is neither glamorous nor easy, and I think the FDIC does excellent, excellent work and excellent public service.

But the perspective is a narrow one. There is a reason we don't have our funeral directors and life insurance companies dictating every aspect of our lives. There would be no airplanes. There would be no deep sea research. And there certainly wouldn't be anybody——

[Laughter.]

Mr. STENGEL. ——there would be nobody walking outside of those white lines of the crosswalks.

Chairman DODD. Dodd-Frank has funeral plans all through here——

[Laughter.]

Mr. STENGEL. There is no life in that world and there certainly is no economic recovery. We do need to be very prudent and have cautious risk management, but we need to be able to breathe.

Those two issuers that Mike referenced are on the Council and we have heard in no uncertain terms that there were programs developed, very unique structures because we have much more debtor-friendly insolvency laws in the United States than exist in Europe, so we are already starting from an investor standpoint with strikes against us. There was a very elegant and careful structure created, but it is one of a bygone era, one of a very frothy market which is not with us anymore and we don't foresee coming again.

So I am very confident in the instructions that I have been given from our Council to say that without those twin pillars, the public

supervision and the separate resolution process, we should shift the focus to other avenues.

Chairman DODD. Mr. Snowden, any comments, or Mr. Campo?

Mr. CAMPO. Yes. I think it really gets down to balance, because what we are talking about here is the balance between sort of what product is used to finance housing overall. Between now and 2015, it is predicted by the Harvard Joint Center that two-thirds of the households will be renters. That is six million people. And what is happening right now in the marketplace is that the multifamily business is doing very well with the existing model, as evidenced by Freddie Mac making $1 billion in profits net of charge-offs that have been used to fund the losses they have experienced on single family.

So we as an industry know that we have to finance. We know that the balance between our financing models needs to change over time and it is all about sort of a balanced housing policy in conjunction with a balanced finance policy and I think covered bonds are clearly an area that make some sense, but we just have to be thoughtful about it where we are not crowding out other parts of the financial market.

Chairman DODD. I agree with that.

Senator Corker.

Senator CORKER. Well, thank you, and I want to thank, even though Mr. Snowden and Mr. Campo, I have no questions, I want to thank you for the historical perspective, which is also always very useful, and certainly some of the rubs that you can create in the multifamily market by taking away resources, I appreciate you saying that and agree with the Chairman that certainly having more affordable rental stock might help in certainly times like right now.

But I want to move back to the first three and say that I know we are not going to resolve the issue of the rub today and I look forward to having, seriously, both of you all in our conference room and trying to figure out a way to resolve that rub.

But I do want to go back to something Senator Reed mentioned because we will be talking about just home finance, mortgage issues, I think, in a very focused way over the next year or so. The issue of personal recourse loans, I have to be candid, I was a fairly sophisticated borrower and was shocked when I got to the Senate and realized that people had no recourse mostly in residential loans. And I know that as we tried to address that during the debate on Dodd-Frank, we realized there were some State Constitutions around this country that kept there from being any recourse against home mortgages. I don't know how many there are. There are a handful. But what happened, I guess, over time is the mortgage industry said, look, it is just easier not to have recourse if some States you cannot do that.

What impact do you think that would have, though, if somehow or another we were able to create a situation where there was personal recourse on home mortgages? What would that do to the durability, if you will, of the mortgage market and what effect do you think that would have?

Ms. WILLIAMS. The imponderable there is to what extent that the existence of personal recourse would significantly affect default

rates, and I don't know personally how to answer that question right now.

Mr. KRIMMINGER. I would just note that I think I agree with Ms. Williams. I think it is hard to predict exactly what the effects would have. I mean, obviously, there are many States in which there is recourse. There tends to be a very involved process, of course, of going through a judicial foreclosure process in order to retain that recourse right, so many lenders simply avoid the judicial foreclosure route and go through a more streamlined route and don't have the recourse.

It certainly might, if there is an impact upon defaults, reduce the cost of mortgages to some degree, but it is really hard to predict because you would need to have some real comparisons to make any judgments about the potential risk impact on the mortgage lending process, either from the investors' or from an issuer's perspective. It is a little unclear at this point.

Senator CORKER. Mr. Stengel.

Mr. STENGEL. I think that is an incredibly difficult issue and I think it is one that not only needs to be explored in the economic context of default, but how individuals are living their lives and able to maintain a certain standard of living. So I think that is an extraordinarily complex part of the debate and might well be that be one of the options and that might make a lot of economic sense in whatever comes out of housing finance reform. But I am certainly neither edified nor intelligent enough to speak on it today.

Senator CORKER. Our resident historian?

Mr. SNOWDEN. Yes, neither edified nor——

[Laughter.]

Mr. SNOWDEN. In any case, that was very well done. We do have a little experience of what happens. The problem with judicial foreclosures, they have to be fair. This is one of the examples, mortgage market institutions generally work very well for idiosyncratic risk. It is when the system gets dumped and you have lots of foreclosures.

And so what has happened is in the 1930s, we had 23 States pass foreclosure moratoria. We just stopped the process because no longer can the recourse—without a fair market, you cannot determine what the amount of recourse ought to be. Well, the argument is anyway, and it is persuasive enough that we see that.

So I would be—I think it would work very well on idiosyncratic risk. I don't think it would fix what we are going through right now. I think it would be very difficult to maintain recourse in this environment and has been.

Senator CORKER. As a practical matter, it would be tough. Should we—on the covered-bond market, should we—one of the writers gave us some input before we came today and mentioned that one of the problems with the House bill is there is no homogeneous fashion to these covered bonds. I mean, you are talking about cats and dogs. Should we look at that as one of the criteria on covered bonds, to create a slightly more homogeneous nature for the loans that would be in these covered-bond sales?

Ms. WILLIAMS. I think that the—your starting point is determining what your threshold eligible asset categories would be, and then you certainly could specify as a direction that there should be

some principle or desirability of the nature of the loans being homogeneous. I think that from the perspective of the issuer trying to put together a pool and determine what the appropriate collateralization, overcollateralization level would be and just the predictability of the risk, the issuers are going to be attracted to having loans that are of a homogeneous type in the covered-bond pools as opposed to having lots of sort of cats and dogs.

Mr. KRIMMINGER. If I might note, as well, we worked very closely with the Treasury Department in mid-2008, early 2008 on the development of what was viewed at that time as the gold standard for covered bonds. It was issued as a Treasury Department document in August of 2008. Obviously, we know what happened in September, so nothing really happened as a result of it.

And one of the principles behind that gold standard was that if you create a very high standard for the types of collateral that would be in the cover pool and you create a homogeneous pool, particularly with some substitution rights, then it would give investors more confidence starting out in the market. Then the market could be expanded beyond that as the market gets more solidified.

And despite being described a bit as the dead hand of insolvency, I think the FDIC is in the market on a very frequent basis and what we are seeing really in the marketplace is I think there is certainly interest in different types of investment vehicles, but what we are really talking about when you get down to the brutal facts of it is money. You know, different options that we are talking about are really affecting how much money the issuers are going to make, much more than how interested investors will be in the particular product, because there are ways of dealing with that acceleration risk. I think there are ways of trying to accommodate all of these issues, and hopefully we can work those out.

Mr. STENGEL. I certainly didn't mean to suggest dead hand, not at all.

There is some irony, of course, in the gold standard because it is highlighting the fact that it should have a lot of high-quality assets, so I think it highlights Ms. Williams' comment about there is some balance here. We want risk retention, but we don't want a lot of high-quality loans all going into cover pools while bad loans stay behind. So there is some balance on that particular issue.

We have viewed at least the approach to covered bonds as being layered, the legislative framework providing the foundation. As Ms. Williams suggested, more specific regulator descriptions about eligibility in the cover pool, if homogeneity is important, if a certain style of loan, a certain either kind of product or certain quality, and then on top of that, individual transactions may differ. So the legislative framework would be the foundation on top of that regulation setting a minimum standard with more specificity, and then within those boundaries, individual issuers could go out and do transactions, and I think the view of the Council, including the institutional investors on our Council, is that there will be a lot of homogeneity to begin with, and the market will dictate a lot of that.

Senator CORKER. Mr. Chairman, I know that you are a short-timer and there is probably some celebratory lunch that you need to go to, so I will stop now——

[Laughter.]

Senator CORKER. ——and I look forward to carrying on this conversation with these folks later on. But thanks for having a most interesting hearing at a time when nothing much else interesting is happening. Thank you.

Chairman DODD. And that lunch is with my niece, who has come to town.

[Laughter.]

Chairman DODD. So it has come down to your family at the end of your career. No one else will have lunch with you.

[Laughter.]

Chairman DODD. It has been a good hearing, very informative. And again, to both of our lead witnesses here, we thank you for your service. Just listening to the two of you, how valuable it is to have people with your background and knowledge, and I appreciate Mr. Stengel talking about the relationship you and Michael have had over the years just in dealing with these issues. That is a comforting note, that you actually talk with each other with some frequency about these matters, as well. So that is an encouraging sign.

At a time when we realize the environment we are in, but I think it is important in an environment like this to remind in a public setting that we are so blessed in this country to have talented people who give their lives to public service, and the two of you have and I want to express my gratitude to you.

The Committee will stand adjourned.

[Whereupon, at 11:41 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Today, the Banking Committee will hear testimony on covered bonds, a potentially significant alternative means for raising capital for housing finance. Covered bonds have been issued widely in Europe for many years, but not in the United States. The purpose of today's hearing is to learn more about covered bonds, exploring whether they could contribute to sustained economic growth and whether it is in the public interest to encourage their broader use in the United States.

The hearing grew out of discussions on covered bonds that came up during the latter part of the Senate–House conference for the Dodd-Frank Act. I am pleased to have worked with Ranking Member Shelby and Senator Corker in organizing the hearing. As the Banking Committee has not previously held hearings on covered bonds and the subject has raised issues among Federal regulators, we determined to explore the matter more carefully before acting.

When speaking of a covered bond in the U.S. context, we generally mean a debt security issued by a bank and backed by cash flows from mortgages or public sector loans. The bond is backed both by the bank's promise to repay and by the assets pledged as collateral.

Covered bonds can provide an additional option to the two dominant funding mechanisms in the U.S. marketplace, which are securitization and the traditional portfolio lender model, where a bank holds mortgages on its balance sheet and funds them with deposits. Proponents of covered bonds point to their greater transparency, because these assets remain on a bank's balance sheet so investors can analyze their value more easily than in the case of some other asset-backed securities. Proponents also note that issuers of covered bonds have a long term interest in the underlying loans because they keep them on the balance sheet, which increases investor confidence.

While American banks are not prohibited from issuing covered bonds to raise capital, few currently do so. Some potential investors are concerned about the treatment of covered bonds if the issuer goes into conservatorship or receivership. They believe that legislation and agency rulemaking are needed to provide clarity about how covered bonds would be regulated. Any such measures would define the rights and responsibilities of investors, issuers, and regulators. They feel that this would stimulate the growth of a larger domestic covered-bond market.

It is important that Congress look for alternative measures that could stimulate the economy. The Committee is holding today's hearing to learn more about this alternative and whether it will contribute to safe, stable, and sustained economic growth.

We are pleased to have before us experts who will provide testimony about the history of covered bonds, their uses and potential benefits, as well as their interaction with existing mortgage financing mechanisms. The panel also includes Federal regulators who can share their perspective on the regulation of banks that would issue covered bonds, including the impact on the Deposit Insurance Fund.

On the first panel, I am pleased to welcome Congressman Scott Garrett, who has a strong interest in this area and introduced legislation on covered bonds. On the second panel, we will hear from Julie Williams, Chief Counsel and First Senior Deputy Comptroller, Office of the Comptroller of the Currency; Michael Krimminger, Deputy to the Chairman, Federal Deposit Insurance Corporation; Scott Stengel, on behalf of the U.S. Covered Bond Council; Professor Kenneth Snowden, University of North Carolina at Greensboro; and Mr. Ric Campo, on behalf of National Multi Hhousing Council and the National Apartment Association.

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you, Mr. Chairman. While covered bonds have been used in Europe, they are not widely used here. I look forward to hearing from our witnesses regarding the potential for a covered-bond market here in the United States.

In addition to various covered-bond proposals being considered by the Congress, it is important that we explore the many different ways mortgage markets are structured and their ability to maintain stability through the recent economic downturn. As our economy stabilizes, the Dodd-Frank Wall Street Reform bill is implemented and we look towards a new structure for the housing finance system, we will need to have extensive discussions about the benefits and pitfalls of any potential changes.

We face a fragile housing market and our decisions should not exacerbate that situation. It is our responsibility to ensure that the regulatory structure will support a functioning housing market and maintain long-term, fixed-rate mortgage financing at reasonable interest rates. I look forward to learning from our witnesses—spe-

cifically how covered bonds might achieve this goal, what parts of the banking sector have the capacity to utilize cover bonds and how other covered-bond markets have responded to the economic downturn.

PREPARED STATEMENT OF REPRESENTATIVE SCOTT GARRETT

Thank you, Chairman Dodd and Ranking Member Shelby, for holding this hearing today and inviting me to testify before you. I also want to thank Senator Corker for all of his hard work and advocacy on creating a U.S. covered-bond market.

As our Nation continues to recover from the recent financial crisis and certain credit markets remain locked, Congress must examine new and innovative ways to encourage the return of private investment to our capital markets. We must also consider creative ways to enable the private sector to provide additional consumer, commercial, public sector, and other types of credit. Establishing a U.S. covered-bond market would further these shared policy goals.

One reason I am particularly fascinated with covered bonds is the fact that they can be a purely private means of finance without Government guarantees or subsidies. Many proposals to help alleviate the current strains in our credit markets focus on Government loans or guarantees. However, I believe covered-bond legislation offers a way for the Government to provide additional certainty to private enterprise and generate increased liquidity through the innovation of a new marketplace without putting the taxpayers on the hook.

There are many potential benefits for a wide variety of interested parties that can be derived from a U.S. covered-bond market:

- Consumers will experience lower loan rates because of the additional liquidity in the various asset classes.
- Consumers will also be able to more easily have their loans modified because the loans will still be on the balance sheet of the originating institution.
- Investors will have a new transparent and secure vehicle to invest in. This will allow for additional diversification within their portfolios.
- And finally, the broader financial markets will benefit by having an additional, low cost, diverse funding tool for financial institutions.

Covered bonds will ensure more stable and longer term liquidity in the credit markets, which reduces refinancing risks as well as exposure to sudden changes in interest rates and investor confidence. And they will allow U.S. financial institutions to compete more effectively against their global peers.

In the House, we have worked in a very constructive bipartisan fashion to push the ball forward on comprehensive covered-bond legislation. Chairman Kanjorski, Ranking Member Bachus, and I have introduced three different versions of covered-bonds legislation. The most recent is H.R. 5823, the U.S. Covered Bond Act of 2010.

A week before the August recess, we successfully marked up the legislation and reported it out of Committee by a unanimous vote. It is my hope that we can pass this legislation out of the House over the next several weeks.

Some have asked why we need covered-bond legislation. Simply, to get the market off the ground and provide investors with the needed confidence to invest in the product, the resolution procedure of a bond when an issuer fails needs to be spelled out specifically in statute. Otherwise, without the certainty of a legally binding process, there is not significant enough appetite from the investor community to make covered bonds cost-effective for issuers to offer. Also, a regulatory regime needs to be put in place to ensure proper oversight of the marketplace.

Throughout this process, there have been some people who have said, "Let's wait and do this next year with housing finance reform." But the proposal we are discussing today is broader than just housing finance. Covered bonds offer a complementary source of funding that can spur much-needed lending to consumers, small businesses, and State and local governments.

The reason why I have been so active in pushing covered bonds this year is because I believe they could help NOW. We hear almost daily about the liquidity concerns throughout various asset classes. The House Financial Services Committee held a recent hearing about the lack of liquidity in the Commercial Real Estate market. The Senate just passed a bill already approved by the House with the intent of providing more liquidity to small businesses.

Also, we have all spoken to local and State officials about the problems municipalities face with increased funding costs for their projects. The President has continuously stressed the need to help these segments of the economy and this legisla-

tion is one we can pass immediately. More importantly, this is something we can pass immediately at NO cost to the taxpayer.

Another reason to move quickly on establishing a covered-bond market in the U.S. is because billions of U.S. investment dollars are moving overseas and north of the border. So far, in 2010, there have been a dozen covered-bond deals issued by foreign banks to U.S. investors totaling close to $18 billion. This is U.S. private capital that could be invested here and help with our consumer needs.

Private industry realizes that we are currently missing out on an opportunity as well. I have formal letters of support for the U.S. Covered Bond Act from: the National Association of Realtors, the Mortgage Bankers Association, the American Bankers Association, the National Multifamily Housing Council, the National Apartment Association, the CRE Finance Council, the Real Estate Roundtable, SIFMA, the American Securitization Forum, the Financial Services Roundtable, and others.

Now, I don't pretend to believe that covered bonds are some sort of magic bullet that will help solve all of our funding needs. However, what I do know is that during a time of economic uncertainty, lack of liquidity and rising budget deficits, we must consider innovative approaches to help attract private investment back into our capital markets. I believe this legislation can help us in that regard.

I thank the Chairman and Ranking Member again for holding this hearing and inviting me to testify. I look forward to any questions you may have.

PREPARED STATEMENT OF JULIE L. WILLIAMS

FIRST SENIOR DEPUTY COMPTROLLER AND CHIEF COUNSEL, OFFICE OF THE COMPTROLLER OF THE CURRENCY

SEPTEMBER 15, 2010

Introduction

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, my name is Julie Williams and I am the Chief Counsel and First Senior Deputy Comptroller at the Office of the Comptroller of the Currency (OCC). I appreciate the opportunity to testify on behalf of the OCC today about covered bonds, their potential uses and key issues that they present for policy makers.

The OCC recognizes that covered bonds can play a role in an institution's overall funding strategy, offer a new source of funds for lending activities, and provide an alternative source of liquidity for financial institutions. Over the past few years, the OCC has supported efforts to remove obstacles to the development of this market.

My testimony today first briefly reviews the characteristics of covered bonds and their pros and cons relative to other funding options. The second portion of my testimony focuses on a set of key issues that would define the essential framework for a statutory covered-bond program.

Part I. General Information on Covered Bonds

Covered bonds are debt obligations issued by a financial institution. The bonds are backed both by the institution's promise to pay and by a dynamic pool of assets pledged as collateral that comprise what is referred to as the "cover pool." The underlying assets are typically high quality assets, subject to various eligibility criteria and must be replaced by the institution should they fail to meet specified criteria. Investors look first to the institution to make payments on the bonds, but investors also have a claim against the cover pool that has priority over unsecured creditors of the institution. This is commonly referred to as the "dual recourse" feature of covered bonds. There is no single definition of a covered bond, however. Covered bonds have been issued using different transaction structures and sold with varying features in many European countries for centuries.

Covered bonds may provide financial institutions, including depository institutions, an alternative to securitization and other funding options. For the banking system, covered bonds provide a funding source that is longer-term and more stable, and potentially less expensive than currently available alternatives, and may also require less collateral or accommodate broader types of collateral than current options. Because the bank retains the credit risk on the collateral for a covered bond, it has a strong incentive to maintain prudent underwriting standards for those loan assets. The structure of risk associated with covered bonds also may attract types of investors that would not otherwise invest in general bank debt.

Covered bonds are well-established in Europe as a means for facilitating mortgage financing. Many European jurisdictions have a public supervisor specifically dedicated to set uniform standards and regulate covered bonds. A statutory structure

for covered bonds in the U.S. would potentially remove one obstacle to growth of a U.S. covered-bond market.

A. Comparison With Securitization

Covered bonds differ from typical securitizations in ways that offer benefits and disadvantages. Investors may have more confidence in covered bonds because they are less complex and more transparent. [1] As noted above, covered bonds provide investors dual recourse against the issuer and the cover pool, which is segregated and managed exclusively for the benefit of the covered bondholders. In contrast, securitizations in the past typically have been off balance sheet transactions and provide investors fewer sources of repayment.

The collateral underlying covered bonds is dynamic—underperforming or prepaid assets must be substituted with performing assets. Assets underlying securitizations are typically static, with the notable exception of credit cards. In the case of default, covered bonds are structured to avoid prepayment prior to maturity, whereas securitization investors are subject to prepayment risk in the event of a default on an asset held as collateral or prepayment of such assets.

Covered-bond issuers typically have a longer-term interest in the performance of the assets underlying the cover pool than issuers in typical securitizations because of the bonds' structure and dual recourse features. In addition, the cover pool typically remains on the financial institution's balance sheet, whereas the assets backing a securitization usually do not. This may give investors more confidence in covered bonds because it creates an incentive for the institution issuing the covered bond to adhere to strong underwriting standards. This feature also may enhance the transparency of covered bonds because covered bonds are not structured into complex tranches.

Covered bonds also permit issuers to lengthen the maturity profile of their liabilities by issuing bonds with long-dated maturities to support long-dated assets. This may enhance the ability of banks to avoid maturity mismatches in their assets and liabilities. But, compared to securitizations, an increased reliance on covered bonds also could increase maturity mismatch risks because of the difficulty in forecasting with certainty the actual maturity of many loan products. In contrast, for securitizations, banks can sell their longer term assets and avoid maturity mismatch risks associated with longer-dated mortgages and other similar assets.

Because covered bonds remain on an institution's balance sheet, the institution must hold more capital than in a typical securitization. Thus, capital requirements could constrain the growth of the covered-bond market. New accounting rules, upcoming changes in capital rules that may require higher levels of capital for assets held on a bank's balance sheet, and the "skin-in-the-game" securitization provisions in the recent Dodd-Frank Wall Street Reform and Consumer Protection Act, which require forms of risk retention for securitizers of loans, are among the factors that may have an impact going forward on the relative advantages and disadvantages of covered bonds and securitization for financial institutions.

B. Comparison With Other Funding Options

Covered bonds also offer a potentially less expensive and more liquid funding source compared to senior, unsecured debt.

In contrast to Federal Home Loan Bank (FHLB) advances, for example, covered bonds offer issuers access to a potentially wider investor pool. Financial institutions may issue covered bonds without becoming a member of a FHLB. Covered bonds could offer more attractive pricing, transparency, and lower collateral levels than some FHLB requirements. The amount, type, and quality of collateral pledged to covered-bond issuances also may provide institutions with additional options to obtain funding. The extent to which there are advantages will depend upon details of how the U.S. covered-bond program is implemented as well as other regulatory developments mentioned above.

Part II. Key Issues for the Framework of a Covered-Bond Program

The U.S. does not have a specific statutory covered-bond framework, although various legislative and regulatory efforts have emerged over the past few years, particularly in response to recent years' mortgage market turmoil. These proposals have included a variety of mechanisms for designing a U.S. covered-bond regime. The appeal of establishing a statutory covered-bond framework is to enable a sound and viable alternative funding option for financial institutions, which could enhance liquidity options and foster healthy competition in the funding markets. This needs

[1] Covered bonds have no credit risk tranching as is the case with securitizations.

to be done without compromising the safety and soundness of institutions participating in covered-bond programs.

That said, development of such a framework for a U.S. covered-bond program presents complex issues for consideration by policy makers. The remainder of my testimony focuses on a set of key issues and explores considerations for how those issues could be addressed.

A. What Entities Are Eligible Issuers?

A threshold issue in designing a statutory covered-bond program is determining the type of entity eligible to issue covered bonds under the statutory program. Limiting eligible issuers to entities subject to supervision by Federal financial regulators has the advantage of dedicated financial supervisors that can monitor and control the growth of covered bonds, react to emerging market issues, and generally act to promote safe and sound covered-bond programs by their respective institutions. Expanding eligible issuers beyond such a group of federally supervised institutions, while expanding the number of issuers and volume of issuances, has the disadvantage of issuers not being subject to the same level of oversight.

As provided for in recent legislative proposals, an "eligible issuer" could mean any insured depository institution or any subsidiary; any bank or savings and loan holding company and any subsidiary; any nonbank financial company that is approved by the primary Federal financial regulator for the nonbank financial company; and any issuer that is sponsored by one or more eligible issuers for the sole purpose of issuing covered bonds on a pooled basis. Regarding the last category, a definition that recognizes the issuance of pooled covered bonds from appropriately regulated firms likely would provide greater access for regional and community banks to this market.

B. What Agency or Agencies Should Regulate Covered-Bond Issuers?

Another key issue in designing a statutory covered-bond program is determining the agency or agencies appropriate to regulate the covered-bond issuers and programs. One agency, multiple regulatory agencies, or the Department of the Treasury, are options that have been suggested at various times. Our suggestion is for the Federal financial regulators to be the covered-bond regulators for their respective institutions, and to implement a single, uniform set of standards that are applicable to all covered-bond issuers.

While having one designated U.S. covered-bond regulator has an advantage of inherent uniformity with respect to all covered-bond issuers and programs, it has the disadvantage of not utilizing existing supervisory knowledge and expertise of current Federal financial regulators. Designation of a single covered-bond regulator, particularly depending on the agency chosen (or created), also might incrementally enhance a market misimpression of Government backing of the financial performance of the covered bonds themselves.

Designating an eligible issuer's Federal financial regulator takes advantage of that regulator's existing knowledge of an institution's operations. It would also be consistent with the current regulatory approach which provides financial regulatory agencies with responsibility for supervising covered-bond programs by institutions under their jurisdiction.

Recent legislative proposals have taken this approach to structuring a U.S. covered-bond framework, proposing that the covered-bond regulator be an eligible issuer's Federal financial regulator. Thus, in the case of national banks and (going forward for Federal thrifts), the covered-bond regulator would be the OCC. For State-chartered, nonmember banks and State-chartered thrifts, it would be the FDIC; for State-chartered member banks, the Federal Reserve Board, and for any other issuers, it would be the Securities and Exchange Commission (SEC).

Under this framework, as discussed further in Section D below, the designated covered-bond regulators would jointly issue a uniform set of regulations establishing a covered-bond regulatory regime. The statutory framework could provide the covered-bond regulators with authority to approve covered-bond programs of their respective institutions, require the regulators to maintain a public registry of approved programs, and authorize an appropriate funding mechanism for the regulators' oversight of the programs.

In determining the parameters of the programs, the regulators could jointly establish reasonable and objective standards for the covered-bond programs, including eligibility standards for eligible assets, and other criteria as determined necessary. These considerations are discussed in more detail in Section D below.

C. What Types of Assets Are Eligible for Covered Bonds?

Another important component of a statutory covered-bond program is the types of assets eligible to collateralize the covered bonds. Typically, in Europe, covered

bonds are associated with high quality assets comprised of residential or commercial mortgage loans and public-sector debt. While some have advocated a broad statutory spectrum of U.S. asset types, including credit card, student, small business, and auto loans, more recent proposals have tended to narrow the eligible asset classes.

One approach to the question of asset eligibility would be to start with a relatively conservative scope. Thus, for example, policy makers could decide to have the statutory framework initially authorize certain asset classes that typically have more homogeneous product terms and credit risk profiles (*e.g.,* residential mortgages). Authorization also could be provided for the covered-bond regulators to expand the eligible classes going forward on an incremental basis as more experience is gained with covered-bond programs and after careful review of relevant considerations. Asset classes with similar characteristics, *e.g.,* credit cards, would be logical first candidates for expansion.

D. What Standards Are Applicable to Issuances of Covered Bonds?

The question of standards applicable to covered bonds and covered-bond issuers has two facets: How are those standards set and what should the standards address?

For policy makers, determining the standards to be prescribed in the statutory framework *versus* those to be left to regulatory rulemaking involves a balance of factors. Providing detailed standards by statute offers the legal certainty of having the standards set by law, but has the disadvantage of less flexibility for needed changes as covered bonds evolve and regulators ascertain strengths and weaknesses in covered-bond programs and with issuers. Also, different standards may be appropriate for different asset classes. For those reasons, policy makers may wish to direct covered-bond regulators to adopt standards to address particular key areas.

As noted in Section B above, while we suggest that Federal financial regulators are best situated to serve as the covered-bond regulators for the institutions subject to their jurisdiction, we strongly believe that those regulators should implement a common set of rules. Thus, the regulators could be charged with designing the detailed rules that govern covered-bond programs, including any key areas that legislation specifically requires them to address. In order to avoid the risk of interagency gridlock, however, we also suggest that some mechanism be specified to ensure that rules are issued on a timely basis. One option that was considered in a recent legislative proposal was to provide by statute that the Treasury Department would issue the required rules if the covered-bond regulators failed to jointly adopt rules within a prescribed time.

Various types of standards could be embodied in a covered-bond regulatory framework. For example, all covered bonds, by asset class, should have minimum eligibility criteria setting asset quality standards to promote the inclusion of high quality assets in the cover pool. Most European jurisdictions prescribe asset quality criteria for the assets subject to the statutory covered-bond program. Those standards in the U.S. could be set by statute or by the covered-bond regulators through rulemaking. Given the likely detail involved, regulatory standards seem preferable.

It is also important to recognize that there are implications if a depository institution begins to use covered bonds extensively as a funding vehicle, as the institution may have an incentive to pledge stronger credit quality assets for collateral, thus giving investors the priority claim on the institution's best assets and leaving the institution, its shareholders, and ultimately, in the case of insolvency, the FDIC, with weaker quality assets. From this standpoint, regulatory or supervisory standards may be needed to address risk management issues similar to other funding vehicles, including an issuer bank's overall liquidity risk management framework and maintaining covered-bond programs in a manner consistent with safe and sound banking practices.

Covered-bond regulators also should have the authority to impose a cap on the percentage of particular asset types that issuing institutions could use for the covered-bond program. An issuer's total covered-bond obligations as a percentage of the issuer's total liabilities also could be limited. Unrestricted growth in covered bonds could excessively increase the proportion of secured liabilities to unsecured liabilities at an institution, and thus present issues in the event the issuer becomes insolvent. As noted above, if the issuer is a depository institution, this creates concerns, notably with respect to potential losses to the Deposit Insurance Fund.

Another important standard is a designated minimum amount of overcollateralization. Typically the collateral for covered bonds has a market value in excess of the face amount of the covered bonds that it backs, *i.e.,* overcollateralization. Having sufficient overcollateralization helps to preserve the value of the covered bondholders' claims in the event of issuer distress, and the ex-

tent of overcollateralization should also affect the rate the covered-bond issuer must pay to investors.

Covered-bond legislation could authorize the covered-bond regulators to establish minimum overcollateralization requirements for covered bonds backed by different eligible asset classes. As a related standard, legislation also could set forth a framework requiring each cover pool to satisfy an asset coverage test that assesses whether the minimum overcollateralization requirements are met, and obligates the issuer and an independent "Asset Monitor" to confirm on a periodic basis whether the asset coverage test is satisfied.

Legislation also could authorize covered-bond regulators to establish certain types of standards viewed as the most necessary and prudent to start with, and then authorize regulators to adopt additional standards deemed appropriate for particular asset classes. This approach would permit covered-bond regulators to revise standards as more experience is gained with covered-bond programs and regulators obtain a fuller understanding of the relevant considerations.

E. What Are the Consequences of a Default of a Covered-Bond Issuance or Failure of a Covered-Bond Issuer?

A critical component in designing a U.S. statutory covered-bond program is determining the consequences of a default of a covered-bond issuance or the failure of a covered-bond issuer. A key advantage typically associated with covered bonds in Europe is their continuing nature despite a default on the issuance or the insolvency of the issuing institution. Under European special law-based frameworks, usually there is a specific legal framework superseding the general insolvency law of the country. The general premise is that if an issuing institution of covered bonds becomes insolvent (or goes into bankruptcy), the cover pool is segregated and held for the benefit of the covered bondholders. The covered bonds do not automatically accelerate when the credit institution goes insolvent, and the rights of the bondholders are protected.

Without a U.S. legal framework addressing the operation and management of the cover pool in the event of a default or insolvency, U.S. covered bonds will continue to lack predictability and clarity compared to other jurisdictions.

From a general standpoint, there are two distinct situations to be addressed: (1) a default on the covered-bond issuance before the issuer enters conservatorship, receivership, liquidation, or bankruptcy; and (2) the insolvency of the issuer institution. When considering the default of a covered-bond issuance, "default" should be clearly defined for this purpose, and also should clearly address what will happen to the cover pool and the rights of the covered bondholders if a default occurs.

One legislative approach is to define the term "uncured default" to mean a default on the covered bond that has not been cured within the time required by the transaction documents related to the covered bond. In that situation, a separate estate will automatically be created by operation of law and will exist and be administered separately from the issuing institution. The separate estate is comprised of the applicable cover pool and assumes liability for the covered bonds and any related obligations secured by that cover pool. Consideration also might be given to authorizing the covered-bond regulators to establish minimum time periods for an "uncured default" in order to avoid "hair trigger" defaults.

Another area for consideration is statutory provisions addressing the preservation of deficiency claims against the issuer; the creation of a residual interest that represents the right to any surplus from the cover pool; and the obligation of the issuer to transfer applicable books, records, files, and other documents to the covered-bond regulator or another designee. Consideration also should be given to provisions that provide that the covered-bond regulator may elect for an issuer to continue servicing the cover pool for some reasonable and operationally practical period of time.

The second situation to be addressed is the potential for insolvency of the covered-bond issuing institution, and if the issuer is an insured depository institution, the FDIC's statutory role as conservator or receiver. Again here it is important to clarify and address what would happen to the cover pool and the rights of the bondholders.

Similar to the default situation approach, a statutory framework could create a separate estate for the covered-bond program similar to those in certain European jurisdictions. A recent legislative proposal creates a structure with the following general components when the FDIC is appointed as conservator or receiver for an insolvent issuer:

- Creation of a separate estate and provision to the FDIC of an exclusive right for 180 days to transfer the issuer's covered-bond program to another eligible issuer.

- A requirement that the FDIC as conservator or receiver, during the 180-day period, perform all monetary and nonmonetary obligations of the issuer until the FDIC completes the transfer of the covered-bond program, the FDIC elects to repudiate its continuing obligations to perform, or the FDIC fails to cure a default (other than the issuer's conservatorship or receivership).

If the FDIC as conservator or receiver, does not timely effect a transfer of the covered-bond program to another eligible issuer, repudiates its continuing obligations to perform, or fails to cure a default, then the statutory framework could provide for the automatic creation of a separate estate and attendant responsibilities, along the lines previously described.

A comprehensive approach for covered bonds that reflects a consistent and predictable process across the Federal financial regulators would serve to provide certainty and predictability to investors and the marketplace in cases of default. This type of framework would require the covered-bond regulator to act as or appoint a trustee of the separate estate and to appoint and oversee a servicer or administrator for the cover pool held by the estate. Given the nature of the events triggering this aspect of the covered band framework, litigation by unhappy private parties could attempt to draw in the covered-bond regulator. We therefore urge consideration of limitations on actions against, and recognition of sovereign immunity for, the covered-bond regulator acting in its statutorily designated capacities.

A further specific issue for policy makers is the appropriate treatment of any excess amounts from the cover pool once the covered bondholders have been paid in full. For example, a recent approach proposed that a residual interest would be created in the estate that represented the right to any surplus from the cover pool after the covered bonds and all other liabilities of the estate had been paid in full. The issue here is whether the FDIC, or the covered bondholders, receives the excess collateral.

F. What Securities Disclosure Requirements Should Apply to Covered Bonds?

The securities disclosure requirements applicable to covered bonds is the final issue I will highlight in this written statement. Requiring meaningful disclosures and making detailed information available about assets in a cover pool is essential to provide consistency and transparency across covered-bond issuances. Required disclosures, along with appropriate reporting, by different issuers should be standardized to permit comparison of current information by investors. This transparency and consistency are fundamental to the structure and discipline of covered-bond programs.

To assure these goals, covered-bond legislation could direct the covered-bond regulators to adopt uniform disclosure and reporting standards for banks and other issuers. Those standards should cover a number of important areas. For example, covered-bond issuers could be required to provide investors detailed information about the cover pool at the time of issuance and on a periodic (*e.g.,* monthly) basis thereafter. The issuer could be required to provide updated cover pool information, for instance, if more than 10 percent of the cover pool is substituted within a month, or more than 20 percent within a quarter. Issuers also could be required to provide investors the results of monthly Asset Coverage Tests, which typically should validate collateral quality and the proper level of overcollateralization. Similarly, the results of any reviews by an Asset Monitor could be made available to investors, as well as any other relevant material information.

The SEC's disclosure requirements for asset-backed securities (ABS) under Regulation AB provide a useful starting point for developing disclosure and reporting requirements for covered-bond programs. However, because covered bonds do not present the same structural complexities generally possible with ABS, it is probably more appropriate to select from, rather than duplicate, the disclosure requirements of Regulation AB in the case of covered bonds.[2] Thus, it would be important for policy makers to clarify that covered bonds are not "asset-backed securities" for such purposes, and to the extent necessary should address the application of the Federal securities laws to any U.S. covered-bond program.

Conclusion

We are encouraged by the continuing interest in establishing a statutory structure for covered bonds in the U.S. Such a step, prudently structured and implemented, holds promise as an additional, complementary funding source for financial institu-

[2] Covered bonds issued by banks do not appear to fall within the definition of an asset-backed security under the Federal securities law. However, legislation clarifying that covered bonds are not asset-backed securities could provide certainty conducive to the development of covered-bond markets.

tions, and a catalyst for sound competition among the financial product funding alternatives available in the U.S. A complex combination of factors will determine the extent to which these goals are achieved.

I appreciate the opportunity to appear before the Committee today, and I would be happy to answer any questions. Thank you.

PREPARED STATEMENT OF MICHAEL H. KRIMMINGER

DEPUTY TO THE CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

SEPTEMBER 15, 2010

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, on behalf of the Federal Deposit Insurance Corporation (FDIC), thank you for the opportunity to testify on the regulatory and legislative issues posed by covered bonds. The FDIC has long worked with the financial industry to establish a sound foundation for a vibrant covered-bond market that will provide U.S. banks with an additional source of liquidity. These efforts include working with the first U.S. banks to issue covered bonds in 2006 and the FDIC's adoption of a Statement of Policy in mid-2008 to clarify key issues related to deposit insurance and bank resolutions. With this background, we hope our views on the covered-bond market may be helpful for the Committee.

The FDIC supports balanced legislation to create a sound foundation for covered bonds that also promotes market discipline and protects the Deposit Insurance Fund (DIF). In order to meet these goals, we believe that there are three key principles that should be followed. First, the rights and responsibilities of investors, issuers, and regulators should be clearly defined. Second, the investment risks to covered-bond investors should not be transferred to the public sector or to the DIF. Third, the legislative framework should be consistent with long-standing U.S. law and policy, and not unduly impair the interests of depositors and other creditors.

While the FDIC's existing Statement of Policy provides a sound foundation, a properly designed legislative and regulatory framework could further facilitate development of a vibrant covered-bond market. In doing so, however, it is important to not create a new class of investments that appears "risk-free" by providing investors with protections unavailable for any other investment. We have already seen the consequences when risks are mispriced in the market. Most importantly, the risks should not be transferred, implicitly or explicitly, to the Government or the DIF. While covered bonds can be a valuable tool to provide liquidity, they do carry risks that should be considered in fashioning any final legislation.

Our testimony will discuss the FDIC's July 28, 2008, "Policy Statement on Covered Bonds", provide background on covered bonds and their potential role in the financial marketplace, and address the proposed legislation recently adopted by the House Financial Services Committee, H.R. 5823, the "United States Covered Bond Act of 2010."

The FDIC's Existing Policy on Covered Bonds

Before the crisis, the FDIC worked closely with Washington Mutual Bank and Bank of America when they launched the first U.S. covered-bond programs in 2006. As a result of our efforts, the banks were able to issue covered bonds at a competitive price. The 2008 Statement of Policy later adopted by the FDIC's Board of Directors addressed questions from the marketplace about how covered bonds would be treated in the receivership of an issuing bank. The market's reaction to this Statement was very positive and most commentators stated that it provided a solid foundation for the covered-bond market. Shortly after the adoption of the Statement of Policy, the Department of the Treasury issued a companion document entitled "Best Practices for Residential Covered Bonds" to establish greater clarity and homogeneity for the market so that investors would have confidence in future issuances. The FDIC worked with the Treasury Department in developing the Best Practices to create a coordinated framework for the responsible and measured roll-out and further development of covered bonds in the U.S. Unfortunately, the financial crisis disrupted all forms of structured finance. Even during the crisis, however, the FDIC was able to sell Washington Mutual's covered-bond program intact to JPMorgan Chase Bank in a failed bank resolution—demonstrating the effectiveness of the process outlined in our Statement of Policy.

Given the FDIC's existing Statement of Policy, the Treasury Department's companion Best Practices, and the prior successful covered-bond programs developed in cooperation with the FDIC, it is unclear that legislation is necessary to relaunch the market. At a minimum, the FDIC suggests that its Statement of Policy should be

considered as a framework for any legislation in order to provide a sound, balanced foundation for the market.

Covered Bonds in Context

Covered bonds are general obligation bonds of the issuer, normally an insured bank or thrift, with payment secured by a pledge of a pool of loans. During normal operations, like any general obligation corporate bond, investors are paid from the issuing bank's general cash flows, while the cover pool of loans serves simply as collateral for the bank's duty to pay the investors. As a result, both functionally and legally, the cover pool is not the source for repayment as in a securitization, but is simply collateral to secure payment if the issuing bank cannot make payment from its general cash flows.

Another distinction between covered bonds and most securitizations further demonstrates that the cover pools function as collateral and not as sources of payment when covered bonds are not in default. In a covered bond, any loans and other assets in the cover pool that become delinquent must be replaced with performing assets. As a result, the collateral for the covered bond is constantly refreshed—and imposes an ongoing obligation on the issuing bank to produce new loans or other qualifying collateral to replace delinquencies. Finally, the issuer must always maintain more collateral in the cover pool than the outstanding notional or "face" balance of the outstanding bonds. If the issuing bank fails to pay on the covered bond, then the investors have recourse to the cover pool as secured creditors. This is precisely how normal collateral arrangements work in other secured transactions.

Under the long-standing U.S. law applied to all types of secured transactions, secured creditors have a claim to the collateral—here the loans or other assets pledged to secure payment on the covered bond—only to the full amount of their claim for payment at the time of any default. They do not have a claim to any part of the value of the collateral that exceeds their current claim for payment. Any collateral or proceeds in excess of that claim for payment are returned to the debtor or, if it has been placed into bankruptcy or receivership, are used to pay the claims of unsecured creditors. If, on the other hand, the secured creditor's claims are greater than the value of the collateral, the creditor will have a secured claim up to the value of the collateral and an unsecured, general claim for the remaining balance along with other unsecured creditors.

The same rules apply in FDIC receiverships. Secured creditors are fully protected under Section 11(e)(12) of the Federal Deposit Insurance Act (FDI Act) for the amount of their claim up to the value of the collateral. As a result, covered bonds provide two avenues for recovery—from the issuing bank and from the cover pool of collateral. What they do not have, under U.S. law, is a right to keep collateral in excess of their right to payment.

Legislation To Address Covered Bonds

As mentioned at the outset, the FDIC supports balanced covered-bond legislation. We believe this legislation should embody three key principles. First, it should clarify the rights and responsibilities of investors, issuers, and regulators. Second, it should ensure that investment risks are not be transferred to the public sector or to the DIF. Third, it should remain consistent with long-standing U.S. law and policy for secured creditors. Unfortunately, H.R. 5823 would muddy the relationship between investors and regulators, transfer some of the investment risks to the public sector and the DIF, and provide covered-bond investors with rights that no other creditors have in a bank receivership. As a result, this legislation could lead to increased losses in failed banks that have issued covered bonds.

Clarifying Rights and Responsibilities—To clarify the respective roles of investors, issuers, and regulators, we suggest that any legislation establish a regulatory framework for the appropriate Federal regulators to jointly establish standards for covered-bond issuances by regulated institutions. One existing forum for setting such joint standards is the Federal Financial Institutions Examination Council, which includes the Federal regulators and a representative from the Conference of State Bank Supervisors. H.R. 5823 provides an alternative approach—by making the Federal prudential regulators the covered-bond regulators—which could also be workable.

The resulting standards, like the FDIC's Statement of Policy, should address the key elements in covered-bond transactions and the safety and soundness issues that can be implicated by a bank's use of covered bonds. The standards should address the types of collateral, underwriting standards, required over-collateralization, frequency and content of reports on collateral and satisfaction of required overcollateralization, disclosure standards for performance of underlying loans or assets, and the rights of the investors in the event of default. As discussed in greater

detail later, a particularly important element in clarification of investors' rights is the treatment of the covered bonds if the issuer defaults on its payments under the bonds. This is both critical to the investor and to the relative balance of risks retained by the investor or transferred to other parties.

The standards setters for covered bonds should have discretion in expanding the use of covered bonds and categories of cover pool assets as sustainable markets develop and the liquidity of the instruments increases. The gradual expansion of cover pool categories is essential to ensure the quality of covered bonds and of the assets in the cover pools.

Unfortunately, H.R. 5823 appears to go beyond setting standards to provide for detailed oversight of the covered-bond program for the benefit of the investors. This shift of the focus of Federal regulation towards protection of the investment interest of specific investors raises significant questions about the proper role of Federal regulation for individual investment programs. It must be made clear that the Federal regulators are not guarantors of performance by the issuing banks and are not responsible for ensuring that the banks do not breach any of the standards. The Federal Government should not determine the roles, responsibilities, or quality of performance of the issuers or be perceived as protecting the investment interests of specific investors. These are issues best resolved by private contracts based on transparent disclosures about the operations of covered-bond programs. It is important that the federal government is not viewed in any way as a guarantor of performance under the covered bonds. Performance should be a matter of private contract.

In addition, H.R. 5823 would also make the Federal prudential regulators the appointing and supervising authority of trustees that would operate the separate estates of the covered bonds. This level of Government entanglement in what are private contractual matters could lead to an implied guarantee of covered bonds. An implied guarantee of covered bonds would put covered bonds on a near par with the Government sponsored enterprises—a status that should not be granted without strong policy reasons because of the risk that status represents for taxpayers.

Legislation Should Not Increase the Potential Loss to the DIF—Intimately related to the foregoing principle is the key issue for the FDIC—new covered-bond legislation should not limit the FDIC's ability to recover the losses the DIF incurs in resolving a failed bank. To protect the DIF, any covered-bond legislation must preserve the flexibility that current law provides to the FDIC in resolving failed banks—including the options of continuing to perform under the covered-bond program pending a sale of the program to another bank, turn-over of the collateral to the investors, and repudiation—a statutory termination of the contracts—of the covered bond obligation.

Because there is sometimes confusion concerning the FDIC's power to repudiate, it requires some explanation. Repudiation is the ability of the FDIC to terminate (or breach) a contract and then pay statutorily defined damages to the other parties. In the case of covered bonds, repudiation allows the FDIC, as receiver for the failed issuer, to cut-off future claims and end the obligation to replenish the cover pool with new assets. Under the FDI Act, the FDIC will then pay damages to compensate the covered-bond investors.

covered-bond investors, as noted above, are secured creditors of the bank. The amount of their claim is defined by the balance or par value of outstanding bonds plus interest. The FDIC would support covered-bond legislation that clarifies the amount of repudiation damages to be the par value of outstanding bonds plus interest accrued through the date of payment. This provides a remedy that fully reimburses the covered-bond investors. In return, as in any other repudiation, the FDIC as receiver would be entitled to reclaim the collateral in the cover pool after payment of those damages. The FDIC could then sell this collateral and use the proceeds to pay part of the claims of the DIF (which has a claim after meeting its insurance obligation for insured deposits), uninsured depositors, and other creditors of the failed bank.

If the FDIC does not repudiate a covered bond, it should have the authority to continue to perform under the covered bond until it can sell the program to another bank. This would not expose the investors to any loss, by definition, since the FDIC would meet all requirements of the covered-bond program, including replenishment of the cover pool and meeting the overcollateralization requirement. As long as the FDIC is performing under a covered-bond agreement, covered-bond legislation should not limit the time in which the FDIC has to decide how best to proceed.

Any legislation that fails to preserve these important receivership authorities makes the FDIC the *de facto* guarantor of covered bonds and the *de facto* insurer of covered-bond investors. Unfortunately, H.R. 5823 would expose the DIF to additional losses by restricting the FDIC's ability to maximize recoveries on failed bank

operations and assets. This is contrary to a long-standing Congressional goal of preserving the DIF to help maintain confidence in the U.S. banking system.

Over the past several decades, Congress has revised the laws governing the resolution of failed banks on several occasions. However, two of those revisions are crucial to today's discussion. First, Congress required the FDIC to use the "least costly" transaction for resolving insured depository institutions. Second, Congress created depositor preference, which gives depositors a priority among unsecured creditors. Both reforms were designed to reduce losses to the DIF.

Unfortunately, H.R. 5823 would restrict the FDIC's current receivership authorities used to maximize the value of the failed bank's covered bonds. The bill leaves the FDIC with only two options: continue to perform until the covered-bond program is transferred to another institution within a certain timeframe; or hand over the collateral to a separate trustee for the covered-bond estate, in return for a residual certificate of questionable value. The FDIC would not have the authority—which it can use for any other asset class—to repudiate covered bonds, pay repudiation damages and take control of the collateral. This restriction would impair the FDIC's ability to accomplish the "least costly" resolution and could increase losses to the DIF by providing covered-bond investors with a superpriority that exceeds that provided to other secured creditors. These increased losses to the DIF would be borne by all of the more than 8,000 FDIC-insured institutions, whether or not they issued covered bonds.

Limiting the time in which the FDIC could market a covered-bond program to other banks will constrain the FDIC's ability to achieve maximum value for a program through such a transfer. Similarly, preventing the FDIC from using its normal repudiation power will prevent the FDIC from recapturing the overcollateralization in the covered-bond program. The "residual certificate" proposed in H.R. 5823 is likely to be virtually valueless. More importantly, the legislation would provide the investors with control over the collateral until the term of the program ends, even though the FDIC (and any party obligated on a secured debt) normally has the ability to recover overcollateralization by paying the amount of the claims and recovering the collateral free of all liens. Providing the FDIC a residual certificate instead of the ability to liquidate the collateral itself would reduce the value to the receivership estate and would not result in the least costly resolution.

So long as investors are paid the full principal amount of the covered bonds and interest to the date of payment, there is no policy reason to protect investment returns of covered-bond investors through an indirect subsidy from the DIF. However, some market participants have argued that continuing to allow the receiver to exercise its statutory repudiation authority would reduce investors' interest in U.S. covered bonds due to the reinvestment risks. This argument misses the mark both from the perspectives of equitable risk allocations and real financial risk.

As discussed earlier, if there is reinvestment risk, it should be borne by private investors, not the public sector, other creditors, or the DIF. Covered-bond investors should receive full payment for the face value of their bonds plus interest. However, they should not be guaranteed control of the cover pool where it vastly exceeds the actual amount of their claims. In addition, there is no real financial risk if the FDIC repudiates the covered-bond transaction, pays the full value of the outstanding bonds, plus interest, and takes control of the cover pool. If that happens, it simply means that the investors' trustee has a pot of money to reinvest into a guaranteed investment contract—like an annuity—to continue to pay investors the steady stream of bond payments which they are seeking.

The financial returns for the investors will not be different, in any meaningful way, from the return they could expect if they had been able to seize control of the cover pool as H.R. 5823 allows. The reason is that, once seized, the cover pool becomes a static pool with no new loans entering, but with delinquent and paid-off loans exiting. Like a static securitization pool, it will be a diminishing pool of collateral as these loans exit. In addition, like other pass-through investment vehicles, the amount of cash generated in any period can be highly variable because of delinquent or missed payments, prepayments, and payoffs. A mismatch will occur between the bond payment obligations and the remaining cash flows of the cover pool. This mismatch would result in early prepayment of the covered bonds to maintain parity. To the extent investors put in place contingent liquidity and/or credit support mechanisms to reduce the asset/liability mismatch, they also reduce the internal rate of return on the covered bonds or increase the cost of issuance to the financial institution. There would also be administrative or management fees associated with the management of the pool. Finally, investors of a static pool pass-through would be subject to default risk, which would be eliminated by the payment in full of the covered bonds. The net economic consequences of the early redemption of the covered bonds would be roughly equivalent to the cost of managing the assets to

the covered-bond's maturity. However, by giving the FDIC the option to redeem the covered bonds, this cost would not be subsidized by the DIF.

The protections to the insurance fund, depositors and the flexibility afforded the FDIC as receiver of a failed depository institution has become a standard that other countries want to emulate. The flexibility that Congress afforded the FDIC permits us to respond to market conditions at the time of insolvency and to achieve bank resolutions that protect insured depositors at the least cost to the DIF. This is an important public policy that we believe has served the Nation well and should be maintained.

Legislation Should Not Create a "Super-Priority" for Covered-Bond Investors—Under U.S. law, secured creditors are entitled to payment of their claims before unsecured creditors up to the lesser of the full amount of their claim or the value of the collateral. We should avoid upsetting this settled principle of law—which is enshrined both in State commercial law under the Uniform Commercial Code and in Federal and State insolvency law in the Bankruptcy Code and the FDI Act, among other statutes.

Covered bonds do offer some advantages over securitization towards improved underwriting. The potential for improved alignment of the bank's incentives toward better quality underwriting is a consequence of the loans remaining on the bank's balance sheet, the duty to replace any delinquent loans in the cover pool, and holding capital for the loans in the pool. However, these advantages come at a cost. The obligation to replace delinquent loans means that there is a continuing demand for new originations, which can act as a liquidity drain if delinquencies increase. This also means that, as poorer loans are taken out of the cover pool, the remaining balance sheet will consist of more and more delinquent loans. In a receivership, this can lead to greater losses to the DIF—particularly if the FDIC's options to sell the covered-bond transaction are restricted.

Clearly, strong origination standards will continue to be required. The potential stress on issuing banks is illustrated by Washington Mutual Bank, which had to increase the cover pool to almost 150 percent overcollateralization in a failed effort to maintain high ratings for the transaction. This further exacerbated Washington Mutual's asset and liquidity problems.

This example also illustrates another important consideration in covered-bond legislation—investors should not be completely shielded from investment risk and their risk should not be transferred to the public sector or to the DIF. If, as under H.R. 5823, the investors can seize the entire cover pool for the duration of the covered bonds irrespective of the degree of overcollateralization, it will provide a strong incentive for investors to maximize the overcollateralization. Naturally, this will increase pressure on the issuing bank during periods of stress. The ability of investors to seize the entire cover pool will also further reduce the loan assets available for sale by the FDIC in any receivership. If creditors of covered bonds are shielded from all risks, there is a strong possibility that covered bonds could lead to a mispricing of risk and distortions in the market, imperiling banks in the future. On the other hand, if the long-standing treatment of secured creditors is maintained—which would allow the FDIC to pay the outstanding principal and interest on the bonds and recover the overcollateralization—there will be very limited incentive for the creditors to demand increasing levels of collateral as a bank becomes troubled.

The super-priority given covered-bond investors by H.R. 5823 also runs against the policy direction established by Congress in recent legislation. In 2005, Congress enacted Section 11(e)(13)(C) of the FDI Act, which prohibits secured creditors from exercising any rights against any property of a failed insured depository institution (IDI) without the receiver's consent for the first 90 days of a bank receivership.[1] This provision prevents secured creditors from taking and selling bank assets at fire sale prices to the detriment of the receiver and the DIF. More recently, section 215 of the Dodd-Frank Wall Street Reform and Consumer Protection Act mandates a study to evaluate whether a potential haircut on secured creditors could improve market discipline and reduce cost to the taxpayers. This study was prompted by the recognized roles that the run on secured credit and the insatiable demand for more collateral had in the financial crisis of 2008. In contrast, the unprecedented protec-

[1] The only exception to the stay in 11(e)(13)(C) is for qualified financial contracts (QFCs). This exemption is based on the fact that performance of the derivatives markets requires prompt transfer or closeout of derivatives positions, thereby reducing potentially negative systemic effects of counterparty failures. Covered bonds do not meet the definitions as QFCs. Nonetheless, H.R. 5823 gives covered-bond investors a right to retain all collateral that not even secured parties with QFCs receive.

tion for one form of secured creditors—covered-bond investors—in H.R. 5823 runs counter to the policies underlying these provisions.

A further concern created by H.R. 5823 is that it could encourage covered-bond transactions that include "triggers" for early termination or default before a bank is closed by the regulators. Under H.R. 5823, a separate estate, which removes the entire cover pool from the bank's control, is created upon any event of default. Once created, the separate estate and all collateral in the cover pool would be outside the control of the FDIC, as receiver for the bank. The residual value of the pool, and all of the loans, would be outside the receivership and be lost for all other creditors of the failed bank. This additional special protection creates a strong incentive for covered-bond transactions to include a trigger that acts before the bank is placed into receivership. Since such a trigger would deprive the bank of the cash flows from the cover pool and signal to the market its imminent demise, the bank would almost inevitably suffer a liquidity failure. As a result, these early triggers represent another source of increased loss to the DIF.

The FDIC has recommended that the receiver should have the authority to cure any defaults under the covered-bond transaction within 30 days of the appointment of the FDIC as conservator or receiver of an issuer. This would reduce the incentive for covered-bond investors to declare a default and take control of the cover pool in anticipation of an FDIC receivership. Providing the FDIC 30 days to cure a default would allow the FDIC to recapture the value of the overcollateralization in the program for receivership creditors, including uninsured depositors and the DIF. The FDIC would then have the same options to resolve the covered-bond transaction and maximize the value of this asset in the receivership.

Conclusion

The FDIC supports a vibrant covered-bond market that would increase liquidity to financial institutions and enable sustainable and robust asset origination. However, any legislation should avoid promoting development of a covered-bond market by reducing market discipline and protection for the Deposit Insurance Fund (DIF). We believe the principles, described above, will ensure that covered bonds serve as a sustainable investment for bondholders and the financial system. We will continue to work with the Congress, other regulators and market participants on ways to create a sustainable covered-bond market in the U.S.

Thank you for inviting me to appear at this hearing. I will be happy to answer any questions.

PREPARED STATEMENT OF SCOTT A. STENGEL

PARTNER, ORRICK, HERRINGTON AND SUTCLIFFE LLP, ON BEHALF OF THE U.S. COVERED BOND COUNCIL, SECURITIES INDUSTRY, AND FINANCIAL MARKETS ASSOCIATION

SEPTEMBER 15, 2010

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I am grateful for your invitation to testify today on the crucial role that U.S. covered bonds can play in stabilizing our financial system and contributing to our economic recovery.

I am a partner in the Washington, DC, office of Orrick, Herrington & Sutcliffe LLP and a member of the Steering Committee for the U.S. Covered Bond Council (the Council). The Council is a collaborative forum comprised of investors, issuers, dealers, and other participants in the covered-bond market, and we strive to develop policies and practices that harmonize the views of these different constituencies and that promote a vibrant market for U.S. covered bonds. [1]

The precarious state of our Nation's economy has become all too apparent. Weakness persists in the labor market, with almost 17 percent of Americans still unemployed or underemployed. More than half of small-business owners are experiencing cash flow issues and are expecting economic conditions to remain unfavorable for at least the next 6 months. Home prices in the United States have fallen 34 percent since their peak in 2006, and nearly one out of every four homeowners is under-

[1] The U.S. Covered Bond Council is sponsored by The Securities Industry and Financial Markets Association (SIFMA). SIFMA brings together the shared interests of hundreds of securities firms, banks, and asset managers. SIFMA's mission is to develop policies and practices which strengthen financial markets and which encourage capital availability, job creation, and economic growth while building trust and confidence in the financial industry. SIFMA, with offices in New York and Washington, DC, is the U.S. regional member of the Global Financial Markets Association. For more information, please visit *www.sifma.org*.

water on a mortgage. The delinquency rate on loans backing commercial mortgage-backed securities has increased to a record 8.92 percent, even though more loans have been modified in 2010 than in the prior 2 years combined. In this volatile environment, credit remains relatively tight for both families and small businesses, public-sector resources are increasingly strained, and consumers are understandably cautious.

In the Council's view, sustained economic growth begins with a stable financial system. While the Dodd-Frank Act has supplied some important structural elements, there remains a considerable need for long-term and cost-effective funding that is sourced from diverse parts of the private-sector capital markets and that can be translated into meaningful credit for households, small businesses, and the public sector.

We believe that U.S. covered bonds are an untapped but proven resource that could be invaluable in meeting this need. We also believe that, with the success of a fragile economic recovery hanging in the balance, the time for U.S. covered bonds is now.

Much has been written about U.S. covered bonds in the last year, and because not all of the commentary has been entirely accurate, I want to take just a moment to describe this financial tool. At its core, a covered bond is simply a form of high-grade senior debt that is issued by a regulated financial institution and that is secured—or "covered"—by a dynamic cover pool of financial assets which is continually replenished. What distinguishes covered bonds from other secured debt is a legislatively or sometimes contractually prescribed process for managing (rather than immediately liquidating) the cover pool upon the issuer's default or insolvency and continuing scheduled (rather than accelerated) payments on the covered bonds. Over the course of this product's 240-year history, cover pools have included residential mortgage loans, commercial mortgage loans, agricultural loans, ship loans, and public-sector loans, and in the Council's view, loans for small businesses, students, automobile owners and lessors, and consumers using credit or charge cards also are appropriate.

Covered bonds are an effective vehicle for infusing long-term liquidity into the financial system. With maturities that typically range from 2 to 10 years and that can extend out to 15 years or more, they provide a natural complement to the short- and medium-term funding that is available through the Federal Home Loan Banks and the securitization and repo markets. This kind of stable liquidity, moreover, allows banks to turn around and provide long-term credit to consumers, small businesses, and governments without being vulnerable to sudden changes in interest rates or investor confidence. In addition, by using covered bonds to more closely match the maturities of their assets and liabilities, financial institutions are able to reduce refinancing risks that can have a destabilizing influence on the banking system more broadly.

Covered bonds also represent a cost-efficient form of on-balance-sheet financing for financial institutions that, in turn, can reduce the cost of credit for families, small businesses, and the public sector. The importance of this cost efficiency cannot be overstated. Recent accounting changes and increased regulatory capital requirements, as well as continued challenges in the securitization market, have made lending far more expensive. Spreads on long-term unsecured debt, moreover, are substantially wider than the short-term rates that have been pushed down to historically low levels by recent Government initiatives, and these long-term rates could move even higher as the Federal Government exits those initiatives and competes for funding to finance its own budget deficits.

Another benefit of covered bonds is their separate and distinct investor base. These investors are providing liquidity that would not otherwise be made available through the unsecured-debt or securitization markets, and as a result, covered bonds enable financial institutions to add another source of funding rather than merely cannibalize their existing sources. Such diversification, not only in the kind but in the supply of liquidity, is crucial to reducing systemic risk and securing the financial system. With a growing shortage of fixed-income securities of the kind that appeal to rates investors, moreover, covered bonds are attracting as much interest as ever.

Equally important, covered bonds deliver funding from the private-sector capital markets without any reliance on U.S. taxpayers for support. The ongoing debate about GSE reform is a stark reminder of how dependent some parts of the financial system remain on Government intervention. That kind of intervention not only exposes the taxpayers to risk but also creates dislocations in the market that inhibit the private-sector economy from generating a self-sustaining recovery. Covered bonds, which have demonstrated resilience even in distressed market conditions,

can serve as an important bridge from an economy that is limping along on Government support to one that is able to stand and thrive on its own.

Two other features of covered bonds bear mention. First, in contrast to securitization, a financial institution issuing covered bonds continues to own the assets in the cover pool that are pledged as security. This creates 100 percent "skin in the game," and as a result, incentives relating to underwriting, asset performance, and loan modifications are strongly aligned. Second, the success of covered bonds is attributable in no small measure to their high degree of transparency and uniformity. As one of the most straightforward of financial products, covered bonds are a model of safe and sound banking practices.

With covered bonds supplying long-term and cost-efficient liquidity from a separate private-sector investor base, the Council believes that credit will more effectively flow to households, small businesses, and State and local governments. Because covered bonds are ultimately constrained by the balance sheets of issuers, however, they cannot be called a silver bullet, and action still needs to be taken to resuscitate securitization and other parts of the financial markets. But, like some of the measures in the Dodd-Frank Act, covered bonds represent a critical first step—and one that, in this constrained credit environment, is urgently needed now.

To function successfully, however, a U.S. covered-bond market must be deep and highly liquid. Covered bonds are viewed as a conservative and defensive investment, and just as with any other high-grade instrument, investors expect active bids, offers, and trades. Sporadic issuances, one-off transactions, cumbersome trading, and shallow supply and demand are incompatible with covered bonds.

This need for a deep and liquid covered-bond market was recognized by the Treasury Department (Treasury) and the Federal Deposit Insurance Corporation (FDIC) in 2008 when they collaborated to issue, respectively, Best Practices for Residential Covered Bonds and a Final Covered Bond Policy Statement. Regulators and market participants alike hoped that, in the absence of a legislative framework, these regulatory initiatives might serve as an adequate substitute and foster the growth of U.S. covered bonds.

But, during the last 2 years, it has become apparent that regulatory guidance alone will not suffice.

Covered bonds were originated and developed in Europe under legislative frameworks that require public supervision designed to protect covered bondholders, and this precedent has set market expectations. Today, almost 30 countries across the continent of Europe have adopted national legislation to govern covered bonds. These include Germany, France, the United Kingdom, the Netherlands, Spain, Italy, Russia, Denmark, Ireland, Portugal, the Czech Republic, the Slovak Republic, Austria, Hungary, Slovenia, Switzerland, Luxembourg, Sweden, Finland, Norway, Poland, Latvia, Lithuania, Ukraine, Romania, Bulgaria, Greece, Armenia, and Turkey. Even in Canada, where financial institutions have been able to actively tap the covered-bond market because of more creditor-friendly insolvency laws and the unique nature of their cover pools, a legislative framework is being developed.

Dedicated covered-bond legislation and public supervision, from the perspective of market participants, creates a degree of legal certainty that regulatory initiatives just cannot replicate. This kind of certainty is critical because the nature of covered bonds as a high-grade defensive investment with limited prepayment risk has no room for ambiguity on the rights and remedies available at law, especially in the event of the issuing institution's insolvency. Investors will not dedicate funds to this market unless the legal regime is unequivocal and the risks can be identified and underwritten.

To provide an example, if a U.S. depository institution were to issue covered bonds and later enter receivership under existing law, the FDIC has expressed the view that three options are available at its discretion: (1) the FDIC could continue to perform on the covered bonds according to their original terms, (2) the FDIC could repudiate the covered bonds or allow a default to occur, make a determination about the fair market value of the cover pool securing them, pay covered bondholders an amount equal to the lesser of that fair market value and the outstanding principal amount of the covered bonds with interest accrued only to the date of its appointment as receiver, and retain the cover pool, or (3) the FDIC could repudiate the covered bonds or allow a default to occur, leave covered bondholders to exercise self-help remedies against the cover pool, and recover from them any proceeds in excess of the outstanding principal amount of the covered bonds with interest accrued only to the date of its appointment as receiver. Any of these three options would be exercised against the backdrop of a temporary automatic stay that would last for 90 days after the FDIC's appointment as receiver or, at best under the Final Covered Bond Policy Statement, 10 business days after an uncured monetary default (though not an uncured nonmonetary default).

In these circumstances, investors face a number of uncertainties: Which of the three options will the FDIC exercise? When will the FDIC make its choice? How will the FDIC calculate the fair market value of the cover pool, and how long will that process take? Will self-help remedies alone suffice, or will the FDIC instead need to be involved in releasing the cover pool? Will the FDIC challenge the method of liquidation used by the trustee for the covered bondholders? What will happen if the FDIC elects to perform for some period of time and then later repudiate, especially if the cover pool has deteriorated in the meantime? Legal uncertainties like these simply do not exist under the legislative frameworks found in Europe.

Equally troubling to investors and other market participants is the fact that this optionality resides with the FDIC, which has a rather clear conflict of interest because of its fiduciary duty to depositors and the deposit-insurance fund. The conflict was recently highlighted by the FDIC's repeated calls for legislation that would force secured creditors like covered bondholders to take a haircut even if their claims are fully collateralized—a development which, to our knowledge, would be unprecedented in the history of credit. [2]

Although this proposal was not adopted as part of the Dodd-Frank Act, the FDIC's advocacy was sufficiently vigorous to prompt a wide-ranging study on the subject. [3]

Layered on top of these concerns is the obvious incompatibility of a forced acceleration by the FDIC with the core nature of a covered bond. A *sine qua non* of covered bonds is the use of collections and other proceeds from the cover pool to continue making scheduled payments after the issuer's default or insolvency. If forced acceleration were possible, the instrument would no longer be a covered bond but instead would be just plain-vanilla secured debt. In addition, if the FDIC were to take the position that secured claims of investors are limited to the fair market value of the cover pool at a moment in time rather than to its cash flow value over time, forced acceleration would expose them to losses arising from short-term market volatility and liquidity risks that are not part of the economic bargain in the covered-bond market.

For these reasons, the Council has concluded that a well-functioning market for U.S. covered bonds cannot develop without a legislative framework that stays true to the distinctive features of traditional covered bonds. Anything less would preclude issuing institutions—and ultimately consumers, small businesses, and the public sector—from realizing the cost efficiencies that make covered bonds worthwhile.

We are confident, moreover, that such a framework could be constructed in a way to fully protect the interests of an issuer's other creditors (including, in the case of a bank, the deposit-insurance fund) as well as any conservator, receiver, or bankruptcy trustee. Taking a bank receivership as an example once again, we would support a period of up to 180 days for the FDIC to transfer an affected covered-bond program to another eligible issuer so long as all monetary and nonmonetary obligations were performed during that time. [4] If such a transfer turned out to be impossible or inadvisable and the covered-bond program were moved to a separate estate for administration, we believe that the receivership's equity in that estate should take the form of a residual interest that the FDIC could sell or otherwise monetize immediately for the benefit of other creditors and the deposit-insurance fund. We also could support the holder of that equity interest being afforded consent rights over the selection of any servicer or administrator for the estate.

The absence of a legislative framework for U.S. covered bonds is already coming at a cost. European and other non-U.S. issuers have been taking advantage of favorable laws in their home countries and filling the vacuum. Thus far in 2010, over $18 billion in U.S.-dollar-covered bonds have been targeted to investors in the United States. With governments in Europe providing the requisite legal certainty for covered bonds issued by their domestic institutions, we fear that the playing

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[2] *See, e.g.,* Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Statement on Establishing a Framework for Systemic Risk Regulation before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (July 23, 2009); Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Statement on Regulatory Perspectives on Financial Regulatory Reform Proposals before the U.S. House Committee on Financial Services (July 24, 2009); Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Remarks to the International Institute of Finance (October 4, 2009); Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Statement on Systemic Regulation, Prudential Measures, Resolution Authority, and Securitization before the U.S. House Committee on Financial Services (October 29, 2009).

[3] *See,* Section 215 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010).

[4] This would be consistent with the FDIC's existing policy on the treatment of secured obligations. *See,* Federal Deposit Insurance Corporation, Statement of Policy Regarding Treatment of Security Interests After Appointment of the Federal Deposit Insurance Corporation as Conservator or Receiver (March 23, 1993).

field could grow increasingly uneven in the fierce competition among banks for less expensive and more stable sources of funding.

The cost of such an outcome, of course, will be born in the end by families, small businesses, and governments throughout the United States, especially those that are dependent on banks for their liquidity needs. When possible, the higher funding costs will be passed along to them; when not, credit will be denied altogether. Neither result can be described as at all desirable.

The Council, therefore, fully supports the kind of comprehensive covered-bond legislation that was proposed by Congressman Garrett and the other House conferees during the House–Senate conference on the Dodd-Frank Act.

In particular, the Council endorses the following elements of a legislative framework for U.S. covered bonds:

- *Public Supervision by a Covered-Bond Regulator*—The public supervision of covered-bond programs by a Federal regulator, whose mission is the protection of covered bondholders, is central to any legislative framework. In the European Union, this feature is enshrined in Article 22(4) of the Directive on Undertakings for Collective Investment in Transferable Securities (the UCITS Directive). Compliance with Article 22(4) is what gives covered bonds their unique status in Europe, including privileged risk weighting under the EU's Capital Requirements Directive and preferential treatment by the European Central Bank in Eurosystem credit operations.

  We therefore support a framework that includes the following: The Comptroller of the Currency or another U.S. Government agency—excluding the FDIC because of its conflict of interest—would be appointed as the Covered-Bond Regulator, which would have as its mission the protection of covered bondholders. The Covered-Bond Regulator, in consultation with other applicable primary Federal regulators, would ensure compliance with legislative requirements and would establish additional regulatory requirements that are tailored to the different kinds of covered-bond programs. Covered bonds would fall under the legislative framework only if issued under a covered-bond program that has been approved by the Covered-Bond Regulator in consultation with the issuer's primary Federal regulator. The Covered-Bond Regulator would maintain a public registry of approved covered-bond programs.

- *Eligible Issuers*—Issuances by regulated financial institutions is another fundamental element of covered bonds that is also recognized in the UCITS Directive. In order to afford competitive market access to regional and community banks, however, pooled issuances by entities that have been sponsored by one or more regulated institutions should be permitted as well.

  We therefore support a framework that includes the following: Eligible issuers of covered bonds would be comprised of (1) FDIC-insured depository institutions and their subsidiaries, (2) bank holding companies, savings and loan holding companies, and their subsidiaries, (3) nonbank financial companies that are approved by the Covered-Bond Regulator and other applicable primary Federal regulators, and (4) issuing entities that are sponsored by one or more eligible issuers for the sole purpose of issuing covered bonds on a pooled basis.

- *Covered Bonds*—To ensure that covered bonds retain their essential attributes as the market evolves, we support a framework that includes the following: A covered bond would be defined as a nondeposit senior recourse debt obligation of an eligible issuer that (1) has an original term to maturity of not less than 1 year, (2) is secured by a perfected security interest in a cover pool which is owned directly or indirectly by the issuer, and (3) is issued under a covered-bond program that has been approved by the Covered-Bond Regulator.

- *Cover Pool*—One other indispensable feature of covered bonds is a cover pool that contains performing assets and that is replenished and kept sufficient at all times to fully secure the claims of covered bondholders. This too receives specific mention in the UCITS Directive.

  We therefore support a framework that includes the following: The cover pool would be defined as a dynamic pool of assets that is comprised of (1) one or more eligible assets from a single eligible asset class, (2) substitute assets (such as cash and cash equivalents) without limitation, and (3) ancillary assets (such as swaps, credit enhancement, and liquidity arrangements) without limitation. No cover pool would include eligible assets from more than one eligible asset class. A loan would not qualify as an eligible asset while delinquent for more than 60 consecutive days, and a security would not qualify as an eligible asset while not of the requisite credit quality.

- *Eligible Asset Classes*—The real benefit of covered bonds is long-term and cost-effective funding from the private sector that can be converted into meaningful credit for families, small businesses, and State and local governments throughout the United States.

  We therefore support a framework that includes the following eligible asset classes: (1) residential mortgage asset class, (2) home equity asset class, (3) commercial mortgage (including multifamily) asset class, (4) public sector asset class, (5) auto asset class, (6) student loan asset class, (7) credit or charge card asset class, (8) small business asset class, and (9) other asset classes designated by the Covered-Bond Regulator in consultation with other applicable primary Federal regulators.

- *Overcollateralization, Asset-Coverage Test, and Independent Asset Monitor*—Full transparency, independent monitoring, and regular reporting must be among the hallmarks of U.S. covered bonds.

  We therefore support a framework that includes the following: The Covered-Bond Regulator would establish minimum overcollateralization requirements for covered bonds backed by each of the eligible asset classes based on credit, collection, and interest-rate risks but not liquidity risks. Each cover pool would be required at all times to satisfy an asset-coverage test, which would measure whether the eligible assets and the substitute assets in the cover pool satisfy the minimum overcollateralization requirements. Each issuer would be required to perform the asset-coverage test monthly on each of its cover pools and to report the results to covered bondholders and applicable regulators. Each issuer also would be obligated to appoint the indenture trustee for its covered bonds or another unaffiliated entity as an independent asset monitor, which would periodically verify the results of the asset-coverage test and provide reports to covered bondholders and applicable regulators.

- *Separate Resolution Process for Covered-Bond Programs*—Hand in hand with public supervision is legal certainty on the resolution of a cover pool if the issuer were to default or become insolvent. A dedicated process must exist that provides a clear roadmap for investors, that avoids the waste inherent in a forced liquidation of collateral, and that allows the cover pool to be managed and its value maximized.

  Central to this resolution process is the creation of a separate estate—like the ones created under the Bankruptcy Code—for any covered-bond program whose issuer has defaulted or become insolvent. To ensure that timing mismatches among the assets and liabilities of the estate do not unnecessarily erode the cover pool's value or cause a premature default, both private-sector counterparties and the Federal Reserve Banks should be authorized to make advances to the estate on a superpriority basis for liquidity purposes only. Importantly, however, advances by a Federal Reserve Bank should be prohibited if U.S. taxpayers could be exposed to any credit risk whatsoever.

  Special rules also are appropriate should the FDIC be appointed as conservator or receiver for an issuer before any default occurs on its covered bonds. All interested parties would benefit if the FDIC were able to transfer the entire covered-bond program to another eligible issuer, much like Washington Mutual's program was conveyed to JPMorgan Chase. As a result, the FDIC should be afforded a reasonable period of time (not to exceed 180 days) to effect such a transfer before a separate estate is created.

  In addition, neither an issuer that has defaulted nor its creditors in the case of insolvency should forfeit the value of surplus collateral in the cover pool. To enable this value to be realized promptly by the issuer or its creditors (including the FDIC and the deposit-insurance fund) without disrupting the separate resolution process, a residual interest should be created in the form of an exempted security that can be sold or otherwise monetized immediately. Such an approach should satisfy all constituencies—covered bondholders will be able to rely on the separate, orderly resolution process for their cover pool, and the issuer and its creditors (including the FDIC and the deposit-insurance fund) will not have to wait for that process to conclude before turning any surplus into cash.

  We therefore support a framework that includes the following: If covered bonds default before the issuer enters conservatorship, receivership, liquidation, or bankruptcy, a separate estate would be created that is comprised of the applicable cover pool and that assumes liability for the covered bonds and related obligations. Deficiency claims against the issuer would be preserved, and the issuer would receive a residual interest that represents the right to any surplus from the cover pool. The issuer would be obligated to release applicable books,

records, and files and, at the election of the Covered-Bond Regulator, to continue servicing the cover pool for 120 days.

If the FDIC were appointed as conservator or receiver for an issuer before a default on its covered bonds results in the creation of an estate, the FDIC would have an exclusive right for up to 180 days to transfer the covered-bond program to another eligible issuer. The FDIC as conservator or receiver would be required during this time to perform all monetary and nonmonetary obligations of the issuer under the covered-bond program.

If another conservator, receiver, liquidator, or bankruptcy trustee were appointed for an issuer before a default on its covered bonds results in the creation of an estate or if the FDIC as conservator or receiver did not transfer a covered-bond program to another eligible issuer within the allowed time, a separate estate would be created that is comprised of the applicable cover pool and that assumes liability for the covered bonds and related obligations. The conservator, receiver, liquidating agent, or bankruptcy court would be required to estimate and allow any contingent deficiency claim against the issuer. The conservator, receiver, liquidating agent, or bankruptcy trustee would receive a residual interest that represents the right to any surplus from the cover pool. The conservator, receiver, liquidating agent, or bankruptcy trustee would be obligated to release applicable books, records, and files and, at the election of the Covered-Bond Regulator, to continue servicing the cover pool for 120 days.

The Covered-Bond Regulator would act as or appoint the trustee of the estate and would be required to appoint and supervise a servicer or administrator for the cover pool. The servicer or administrator would be obligated to collect, realize on, and otherwise manage the cover pool and to invest and use the proceeds and funds received to make required payments on the covered bonds and satisfy other liabilities of the estate. The estate would be authorized to borrow or otherwise procure funds, including from the Federal Reserve Banks. Other than to compel the release of funds that are available and required to be distributed, no court would be able to restrain or affect the resolution of the estate except at the request of the Covered-Bond Regulator.

- *Securities Law Provisions*—With covered-bond programs subject to rigorous public supervision, investors will be well-protected. As a result, an expansion of existing securities-law exemptions may be appropriate. Regardless, because legal certainty for covered bonds is paramount, we support a framework that includes at least the following: Existing exemptions for securities issued or guaranteed by a bank would apply equally to covered bonds issued or guaranteed by a bank. Each estate would be exempt from all securities laws but would succeed to any requirement of the issuer to file applicable periodic reports. Each residual interest would be exempt from all securities laws.
- *Miscellaneous Provisions*—We also support a framework that includes the following conforming changes to other applicable law: The Secondary Mortgage Market Enhancement Act of 1984 would be expanded to encompass covered bonds. Covered bonds that are backed by the residential mortgage asset class, the home equity asset class, or the commercial mortgage asset class would be qualified mortgages for Real Estate Mortgage Investment Conduits (REMICs) and, subject to regulations that may be promulgated by the Secretary of the Treasury, may be treated as real estate assets in the same manner as REMIC regular interests. The estate would not be treated as a taxable entity, and no transfer of assets or liabilities to an estate would be treated as a taxable event. The acquisition of a covered bond would be treated as the acquisition of a security, and not as a lending transaction, for tax purposes. The Secretary of the Treasury may promulgate regulations for covered bonds similar to the provisions of Section 346 of the Bankruptcy Code.

In addition to these elements of a legislative framework, the Council also believes that U.S. covered bonds should be afforded favorable regulatory capital treatment like that found in Europe, including in the context of risk weighting and liquidity buffers.

On behalf of the Council, I want to thank Chairman Dodd for holding this hearing and Senator Corker and Congressman Garrett for their leadership on U.S. covered bonds.

I would be pleased to answer any questions that Members of the Committee may have.

PREPARED STATEMENT OF KENNETH A. SNOWDEN

ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF NORTH CAROLINA AT GREENSBORO

SEPTEMBER 15, 2010

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to testify before the Committee concerning the potential uses and regulation of covered bonds in the U.S. mortgage market. I am an economic historian who for the past two decades has studied the development of the U.S. mortgage market. Up until 3 years ago my specialty was relatively obscure even among other historians, but crisis always seems to enhance the value of looking back. The purpose of my testimony is to share with you some of the research I and others have done concerning the history of our mortgage market and the role that covered mortgage bonds have played within it. The hope is that the historical perspective will provide useful guidance as you consider whether and how to incorporate regulated covered bonds into the U.S. mortgage market.

Covered bonds are being recommended for the U.S. mortgage market at this time because they address weaknesses that we have observed over the past 40 years in the two funding mechanisms that have dominated the U.S. mortgage market for the past century. One of these systems is what I refer to here as the traditional portfolio lender model in which an intermediary holds mortgage loans on its own balance sheet and funds them by issuing deposits. In the other funding mechanism that is used extensively in the U.S., called securitization, bonds are issued against a pool of mortgages that has been taken off the balance sheet of the intermediary that originated or assembled the mortgage loan pool. Covered mortgage bonds differ from both of these systems in that the intermediary issues debt that is secured by a pool of mortgage loans that it holds on its own balance sheet. Investors who purchase covered bonds are given senior claims on the designated mortgage cover pool, and also have recourse to the other assets held by the intermediary as security for the promised payments on their bonds. As a result of this structure, covered mortgage bonds can reduce the risks of funding long-term mortgages with short-term deposits that arise in the traditional portfolio lender model, while providing greater incentives to impose strict mortgage underwriting standards than are found in securitization.

Covered mortgage bonds are also being recommended at this time because of their popularity and record of success in Europe. The European record of covered mortgage bond success, in fact, stretches back over 200 years. Although my own research is completely U.S.-centered, I became aware of the history of covered bond use in Europe two decades ago when I came across commentaries by late 19th century writers that complained bitterly about the absence of European-style covered mortgage bond programs in the U.S. These comments provided evidence that market participants in the U.S were well aware of covered mortgage bonds as early as 1870 and led me to question why the mechanism had not been implemented here. Further exploration revealed that covered mortgage bond systems actually had been introduced several times between 1870 and 1935. At that point the important question became why did covered mortgage bonds not become a permanent fixture in U.S. mortgage markets. It turns out that bad timing, poor implementation, and ineffective regulation all played roles, and my testimony briefly surveys that record to provide the Committee with this historical perspective as you consider legislation to encourage the introduction of covered bonds into the U.S. mortgage market one more time.

The history of covered mortgage bonds in the U.S. is messy. It spans the farm and nonfarm residential mortgage market, State and Federal regulatory structures and fundamental changes in mortgage contract design—all during a seven-decade period which saw three mortgage crises, including the most severe one in the 1930s. Before venturing more deeply into this chronology, a brief summary of its highlights and the lessons that I have drawn from it will be useful.

I divide the historical record into two parts. The first lies between 1870 and 1900 when covered mortgage bonds were introduced into the U.S. without the regulatory framework that was used in Europe. The covered mortgage bond had its greatest success during this period when western farm mortgage companies that normally brokered whole mortgage loans began to issue bonds secured by the mortgages instead of selling the loans outright. I have examined one of these companies in depth and found that the loans it placed behind its covered bonds were riskier than those that it brokered. That result appears to contradict the generalization that underwriting standards are strict inside a covered mortgage bond structure; but in this case the issuer could shift risk between two mortgage funding channels because of

ineffective regulation. A more obvious lesson can be drawn from the way these companies failed during the general farm mortgage crisis of the 1890s. Serious malfeasance occurred throughout the covered mortgage bond sector during the crisis because there was no regulation in place to control the behavior of the mortgage companies after their financial capital dissipated. These failures affected the reputation of covered mortgage bond programs in the U.S. for decades.

The Federal Government takes center stage in the history of covered mortgage bonds between 1900 and 1935. Your predecessors in the 63rd and 64th Congresses benefited from an extensive investigation of covered mortgage bond systems in Europe before creating the Federal Farm Loan Bank System in 1916. This system was comprised of both public and private institutions, and both relied on covered bonds to fund mortgages. The privately financed, joint-stock land bank component within the system was structured and regulated just like institutions in Germany which led private farm mortgage companies to oppose and avoid the system because of the restrictions it imposed on activities that were standard practice in the U.S. farm mortgage market. Twenty years later the 73rd Congress authorized the creation of a privately financed, federally regulated covered residential mortgage bond program to provide a liquid market for the new FHA-insured mortgage loans. No private institution was ever chartered under this authority, and the discussion about introducing covered mortgage bonds to the U.S. went silent for decades.

In the final section of my testimony I provide an overview of the development of the institutional residential mortgage market over the past century to provide perspective on how the introduction of covered mortgage bonds at this time fits into its long-run pattern of development. I close this introduction, however, by summarizing three lessons I draw from the historical record:

1. Past failures of covered mortgage bonds in the U.S. are explained by a combination of bad timing, poor implementation, and ineffective regulation. We need to do a better job of incorporating covered bonds into the U.S. mortgage market, rather than abandon the effort.
2. A common failure in past attempts was to transplant elements of European covered mortgage bond systems without tailoring them to fit U.S. institutions. We need to identify features of the U.S. mortgage market that could be incompatible with European covered mortgage bond practice while, rather than after, regulation is being formulated.
3. Finally, history gives us a clear bottom line in this case. If it had been easy to incorporate covered bonds into the U.S. mortgage market, we would have already done so.

Unregulated Early Experiments With Covered Mortgage Bonds

By the mid-1800s covered farm mortgage bonds were trading in Europe in broad and active secondary markets with yields as low as those on Government securities. These bonds were issued by mutually owned institutions (Landschaften) and privately owned, joint-stock mortgage banks in Germany, and by a national monopoly bank (the Credit Foncier) in France. The success of these programs attracted attention in the U.S. where the focus in the mortgage market during the late nineteenth century was on the spatial mismatch of mortgage credit between savings-rich, eastern urban areas and rapidly growing, capital-hungry areas in the Midwest and Great Plains (Davis, 1965). Several innovations appeared between 1870 and 1900 to facilitate the movement of mortgage credit from east to west to arbitrage the substantial differentials in mortgage rates that had appeared. Among these were attempts to establish covered mortgage bond programs patterned after European models, but not subject to the same strict regulatory oversight.

Henry Villard, who was German-born and traveled in Europe as a journalist, is given credit for initially advocating for the importation of the European mortgage system into the U.S. in the late 1860s (Herrick and Ingalls, 1915, 1–2). Villard's attempts to establish a mortgage bank failed, but in 1871 Pierpont Morgan and other respected American and European investment bankers organized a trust under New York law to implement a European-style covered mortgage bond business. The New York board of the U.S. Mortgage Company was charged with the task of assembling pools of high-yielding western mortgages, while the European board took charge of marketing and selling the covered bonds in their home markets (*See,* Brewer, 1976).[1] The focus on continental markets led the firm to adopt the norms and even some of the language of European systems: outstanding bonds could not exceed 20 times paid-in capital and had to be fully secured by mortgages on improved farm

[1] Brewer (1976, 373–380) also examines the mortgage bond business of the Mercantile Trust Company of New York, a subsidiary of the Equitable Insurance Company.

and urban properties with low loan-to-value ratios.[2] The company was incorporated as a trust which meant that its covered mortgage business was virtually unregulated relative to European standards. U.S. Mortgage issued securities successfully for 2 years, but its growth was soon cut short by the Panic and recession of 1873. The company never defaulted on its bonds, but gradually wound down its covered mortgage bond business because marketing western mortgage loans turned out to be too risky and time-consuming to command the attention and risk the reputation of its high-profile organizers (Brewer 1976, 380).

Western farm mortgage companies, unlike U.S. Mortgage, were intimately involved in the western farm mortgage market and much more successful, at least at first, in establishing covered-bond programs. Hundreds of these mortgage companies were organized in the Midwest and Great Plains during the 1860s and 1870s to broker and service individual whole farm mortgage loans for eastern and European investors. In the early 1880s several of these companies began to place whole mortgages that they had originated into eastern trust accounts and to issue covered bonds, then called debentures, against this collateral. The innovation enjoyed immediate popularity, and by 1890 two-thirds of the western mortgage companies that were licensed to operate in New York and Massachusetts were selling their own covered mortgage bonds. By that time the new securities were funding about one-tenth of outstanding western farm mortgage debt.

Investors were attracted to covered bonds because they offered less idiosyncratic lending risk and lower transaction costs than the brokered whole farm loans that the companies had been selling up to that time. In order to issue the bonds, however, the mortgage company had to issue its own debt obligations that exposed it to risk that brokerage did not impose.[3] Starting a debenture program also entailed the costs of incorporating the company and formulating a trust arrangement, most often with an eastern trust company. The trustee was required to evaluate mortgage loans designated for the trust account against criteria the company itself specified—they usually required mortgages written for no more than 40 or 50 percent of the value of the encumbered property. Debentures were issued and sold only after the trustee had certified the collateral. The trustee was also obligated to take control of the assigned mortgage loans on the behalf of the bondholders if the company defaulted on its obligations to them.

An interesting feature of the farm mortgage bond movement is that it provided investors with less information about mortgage loan quality than the brokered loan business it was intended to supplant.[4] In this environment investors who bought covered bonds could have relied on three mechanisms to assure that the bonds were well-secured: the trust arrangement through which debentures were issued, supervision by State regulatory authorities, and the mortgage company's own incentive to uphold underwriting standards in order to protect its own financial and reputational capital. Regulation and trust arrangements provided no effective hands-on supervision, however, so investors relied most heavily on the mortgage company's own "skin in the game."[5] This helps to explain why the debenture movement did not appear until the 1880s after some of the mortgage companies had become large enough and sufficiently well-capitalized in their brokerage businesses to credibly issue their own securities.[6] It also explains why not all western mortgage companies issued debentures; I have recently found that debentures were most like-

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[2] Brewer (1976, 363) provides a fuller description of the bylaws. Brewer (373–380) also examines the mortgage bond business during the 1870s of the Mercantile Trust Company of New York, a subsidiary of the Equitable Insurance Company. Mercantile acted as custodian and guarantor of bonds issued against mortgages that it had taken off of its own books. These, and similar structures discussed below that were issued in the 1920s are classified here as securitizations, not as covered bonds.

[3] The companies sold brokered loans with recourse, but the promise to buy back loans was not a formal, legal obligations as the companies could and did suspend recourse when in distress.

[4] Mortgage companies assigned loans to investors and then mailed applications and documents for investor approval. Loans that investors rejected had to be reassigned to another investor.

[5] Regulation came too late to be effective as western mortgage companies operating in Connecticut, New York and Massachusetts were not required to report even basic financial data to investors until 1889—years after the debenture movement began to expand rapidly. Even at this point the information was self-reported and the companies were not subject to on-sight examinations.(New York, Annual Report (1891), pp. 15–27.) The trustees who administered debenture programs for the mortgage companies were also did not monitor their western lending operations.

[6] The discussion here is summarizes evidence reported in Snowden (2010b).

ly to be adopted, and to be used more intensively, by older, larger companies with strong balance sheets and successful records of performance as mortgage brokers.

A second interesting feature of these covered bonds is that all of the companies that issued debentures continued to broker loans. Mortgage companies that operated these mixed brokerage-debenture businesses, therefore, had to allocate mortgage loans between the two funding channels. I recently examined how that allocation was made in 1887 in one large and highly respected Kansas mortgage company. The evidence shows that the loans placed behind the covered bonds were smaller in size, shorter in term and riskier than those that the company brokered. By packaging these types of loans behind covered bonds the mortgage companies improved the efficiency of the interregional mortgage market by creating a funding mechanism for loans that were difficult and costly to broker. This result provides an interesting counterexample to the generalization that the issuer's "skin in the game" in a covered-bond structure necessarily leads to stricter underwriting standards. It also indicates that combining a covered mortgage bond program with another mortgage funding channel can create incentives to shift risks among the two.[7]

A third interesting feature of the farm debenture movement is its spectacular failure in the 1890s. The backdrop was a general farm mortgage crisis that generated substantial losses for farmers, investors and intermediaries in the western mortgage market. It was not surprising, therefore, that virtually all of the mortgage companies that had issued covered bonds, as well as most of the brokerage-only operations, failed. Many investors were shocked, however, when audits of the failed mortgage companies by eastern regulators found evidence of widespread and egregious violations of the company's own trust agreements within their covered mortgage bond programs.[8] The problem, of course, was that the incentives of the mortgage companies changed dramatically once the financial capital that supported their debenture programs had been exhausted in the broader mortgage crisis. Investors learned the hard way in the 1890s that the "skin-in-the-game" that promotes diligence within a covered-bond structure is not the mortgage loans on the issuer's balance sheet, but the value of its capital.

Federal Sponsorship of Covered-Bond Programs

The Federal Farm Loan Bank System

The spectacular failure of the covered-bond programs of the western mortgage companies was remembered for decades as a cautionary tale. It also left a void in the market for farm mortgages that was filled by a new generation of mortgage companies that relied exclusively on the old system of loan brokerage. The typical farm mortgage contract at the time was a balloon loan with a term of 3 to 5 years that the borrower had to renew one or more times before extinguishing the debt. Between 1908 and 1912 a "Rural Credits Movement" called for Federal intervention into the mortgage market so that farmers in the U.S. could benefit from the same type of long-term, low-cost amortized mortgage loans that had been written for decades within European covered-bond systems (Herrick and Ingalls, 1915a). The movement grew strong enough to pressure President Taft and the Congress to create a commission to investigate European mortgage banking systems and to make recommendations for a publicly sponsored covered farm mortgage bond system. The commission reported back to a joint hearing before the Banking Subcommittees of the Senate and the House in 1914, and that testimony provides an exhaustive discussion of covered mortgage bond practices as it existed at that time in Europe (United States, 1914).

A heated debate arose about which one of several European models would be most appropriate in this country—a quasi-public monopoly bank like the Credit Foncier, a cooperative land credit system along the lines of the German Landschaften, or a regulated system of private joint-stock mortgage banks. The compromise that took shape in the Federal Farm Loan Act of 1916 was a mixed model that included a publicly sponsored cooperative mortgage lending system alongside a federally chartered system of private joint-stock mortgage banks. Both systems were to issue covered mortgage bonds under the supervision of the Federal Farm Loan Bank Board.

The public, cooperative system was two-tiered. The foundation of the system was locally based, voluntary cooperatives that were authorized to make loans to members of the association that met underwriting standards established by the Federal Farm Loan Board. These included a maximum loan-to-value ratio of 50 percent, a

[7] Some of the western mortgage companies placed into trust mortgages written to their employees on property the company had acquired after buying back defaulted brokered loans.

[8] For accounts of similar abuses by other mortgage companies see New York (Annual Report (1891), pp. 16–19). Snowden (1995, pp. 279–281) summarizes regulators' findings and criticisms of both operating and failed farm mortgage debenture companies.

term of 30 years, and full amortization with privilege to prepay. After the loans were made they were sent to one of twelve district Federal Land Banks for approval after which Federal Land Bank Bonds could be issued in equal amounts. The bonds were the joint liability of the Land Banks and the Farm Loan Associations in a structure similar to the German Landschaften.

We are more interested here in the privately financed Federal Joint-Stock Land Banks authorized under the legislation because they shared several features with covered mortgage bond models being considered today. The joint-stock bank charter was designed to attract private lending agencies so that they could issue regulated covered mortgage bonds rather than broker or hold farm mortgage loans. To enter the system the owners had to satisfy the minimum capital requirement of $250,000 and operate under strict regulation borrowed from the German private mortgage bank model (Horton, *et al.,* 1941). Each bank could issue bonds in a volume no greater than 15 times their capital if they were fully secured by long-term, amortized mortgage loans that met the same underwriting standards that were set for the cooperative farm loan associations. Examiners of the district Farm Loan Bank served as the pool monitors in these structures and examined and registered each loan that was approved as collateral. Each joint-stock bank was fully liable to its bondholders, and enjoyed no implicit or explicit Government guarantee. Private rating agencies graded the bonds of each joint-stock bank separately.

The joint-stock bank system was designed to draw in existing private farm lenders, especially farm mortgage companies. But the mortgage companies, instead, ended up opposing the Federal system before and even after it had been passed.[9] The companies were not opposed to covered mortgage bonds, but they argued that joining the system would force them to abandon important elements of their existing business because of specific requirements of the charter. These included a restriction to lend only in the State in which the bank was located and one more contiguous to it, the prohibition on selling loans with recourse, which would have eliminated their brokerage businesses, and a requirement to write only long-term amortized loans so that they could not deal in the standard short-term, balloon loan (Schwartz, 1938, 21–22). The final bill contained none of the modifications suggested by the mortgage companies. In response they then raised objection to another feature of the bill—the bonds of both the Federal District Land Banks and the privately owned joint-stock banks were fully exempt from Federal taxes. The companies pursued the issue after the bill had passed, and their challenge regarding the constitutionality of the tax exemption led to legal proceedings that lasted until 1921 and that retarded the early growth of the system.[10]

Eighty-eight of the privately owned Federal Joint-Stock Land Banks were ultimately chartered under these provisions, most of them before 1925. From then on the banks began to experience difficulties because of general distress in American agriculture, and the system was particularly shaken when three of the joint-stock banks entered receivership in 1927. Once the Depression took hold the Treasury provided relief so that the District Farm Land Banks could manage and supervise the joint-stock banks that were forced to liquidate. Emergency farm mortgage relief legislation that was passed in 1933 placed the remaining joint-stock banks in liquidation and prohibited the establishment of any additional institutions. The six-decade experiment in the U.S. with privately financed, European-style covered farm mortgage bonds had ended.

A Covered Mortgage Bond System for the Residential Market?

With the establishment of the Federal Farm Loan Act proposals soon appeared for the creation of a central residential mortgage bank. The discussion began in 1919, but took more than a decade to resolve. In 1929 the Brookings Institute produced an assessment of "First Mortgages in Urban Real Estate Finance" (Gray and Terborgh, 1929). The report focused on the stubborn disparity in mortgage rates across regions despite the interregional activities of life insurance companies, real estate bond houses and the mortgage guarantee companies during the 1920s. The recommendation, therefore, was to establish a public, European-style central mortgage bank—similar to the Federal Farm Loan Bank system—that could place pools of nonfarm residential mortgages made by local originators behind covered mortgage bonds.

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[9] The opposition to the Federal Farm Bill actually led to the formation of the Farm Mortgage Bankers Association—the precursor to the modern Mortgage Bankers Association (Robins, 1916).

[10] O'Hara (1983) argues that the FHLB tax exemption diverted credit into agriculture and made it more difficult for tenant farmers to purchase land, one of the system's intended goals, by capitalizing the subsidy in higher farm land prices.

By 1931, when President Hoover convened a conference on home building and ownership in the midst of the growing mortgage crisis, it had become clear that a liquidity facility for residential mortgage lenders would soon be created under one of three proposals (Jones and Grebler 1961, 113–114). The National Association of Real Estate Builders supported a Federal system of mortgage banks and joint-stock banks similar to the one recommended by the Brookings Institute. The Hoover administration favored a Federal facility that could discount mortgages for a wide variety of approved mortgage lenders. The U.S. Building and Loan League favored the most restrictive plan, a home loan discount bank for only its members. Its proposal was adopted when the Federal Home Loan Bank System was established in 1932 to serve what would become the modern S&L industry.

The possibility of a federally sponsored covered-bond mortgage system was revisited when provisions to create the Federal Housing Administration and its mortgage loan insurance program were proposed in the National Housing Act of 1934. Although FHA loans were insured by the Federal Government, there was considerable doubt whether private lenders would be willing to invest and hold any long-term, amortized mortgage loan. To encourage participation in the FHA program, Title III of the National Housing Act authorized the FHA to charter privately owned facilities that could provide liquidity for FHA mortgages by issuing covered mortgage bonds that used the loans as collateral. This provision of the bill generated attracted strong objections from the United States Building & Loan League and life insurance companies (United States, 1934a and 1934b).[11] Both groups had reason to be concerned about the potential entrance of a new mortgage lending facility, but their testimony focused as well on the unhappy events associated with the farm mortgage debenture debacle of the 1890s and the ongoing liquidation of the joint-stock farm land bank system. Others witnesses doubted that private capital would be forthcoming given that the housing sector was at the lowest point of the crisis.

Despite the opposition, Title III of the National Housing Act authorized the creation of a system of privately owned, federally chartered National Mortgage Associations to buy and sell FHA loans from mortgage originators. These associations were to be locally based institutions that would buy, hold and sell FHA loans (*See,* Jones and Grebler 1961, 115–119). The legislation did not limit the number or regional distribution of the associations, but required a minimum paid-in capital of $5 million. The bonds issued by an association had to be secured by FHA-insured loans, cash or Federal Government securities, and the total volume of its bonds could not exceed 10 times paid-in capital. By 1937 not one National Mortgage Association had been organized despite modifications to the original legislation designed to attract private investors (Jones, 1961, 116).

In order to demonstrate the viability of the proposed system the Federal Housing Administrator authorized the Reconstruction Finance Corporation to sponsor the National Mortgage Association of Washington in February 1938. It was soon renamed the Federal National Mortgage Association and its first issue of $25 million of debentures was heavily oversubscribed. Despite the success of this experiment, the FHA announced in May that it would no longer process applications for private National Mortgage Association charters so that not one privately owned institution was chartered under Title II of the National Housing Act.[12] The FNMA went on, however, to create a secondary market for FHA loans and, somewhat later, VA guaranteed loans. What had been abandoned, however, were plans to create a federally chartered, private system of institutions that could issue covered residential mortgage bonds.

Covered Bonds and the Long-Run Development of the Market

Although most of our experience with covered bonds took place in the farm mortgage market, we end by focusing on the Nation's nonfarm residential mortgage because it is there that the introduction of covered mortgage bonds in the U.S. today are most likely to affect the long-run development of the mortgage market. Figure 1 provides a view of changes in the structure of that market over the past century.

The turmoil of the past decade pales in comparison to events in the residential mortgage market during the 1920s and 1930s. The volume of nonfarm residential mortgage debt tripled during the home building boom of the 1920s and financed an increase in the rate of nonfarm homeownership from 41 to 46 percent. The note-

[11] The FHA insurance program took up much more of the hearing than any testimony on the National Mortgage Association.

[12] The *New York Times,* May 28, 1938, reported that applications for new NMAs increased after FNMA's successful bond offering, but that with the FHA decision "private interests planning to take advantage of this potential market . . . appear doomed to disappointment or at least considerable delay." p. 25. Jones and Grebler (1961, p. 115) refer to the NMA proposal as a "frustrating episode."

worthy structural change in the mortgage market during the decade was the rapid growth of two forms of privately issued real estate securities that by 1929 funded nearly 10 percent of Nation's outstanding residential mortgage debt. These innovations—single-property real estate bonds and participation certificates issued by mortgage guarantee companies—financed commercial as well as residential development in the Nation's largest urban areas and were primarily directed toward the individual investor who played a much larger role in the residential market at that time. Both of these securities were early forms of off-balance-sheet securitization and were not covered mortgage bonds. [13]

During the 1930s the U.S. experienced record levels of nonfarm foreclosures, widespread distress among mortgage lenders, a collapse and weak recovery in homebuilding, large decreases in home values and a complete reversal of the gains in homeownership made during the 1920s. Against this backdrop the Home Owners' Loan Corporation had a sudden and large impact on the structure of the residential mortgage market (refer to Figure 1). Between 1933 and 1936 this Federal agency operated as both a "bad mortgage bank" (by purchasing distressed mortgages from private lenders) and a loan modification program (by refinancing the mortgages with long-term, high-leverage, amortized loans). In three short years it had refinanced mortgages on one out of every 10 owner-occupied homes and held nearly 10 percent of the Nation's home mortgage debt. HOLC's lending activities ended in 1936 after which the agency existed another 15 years to service its mortgage portfolio. [14]

A second striking change in market structure during the 1930s was the disappearance of the private securitization structures that had grown so rapidly during the previous decade. Although the decline in the share of private real estate securities looks gradual in Figure 1, the actual process was not. Nearly all of the real estate bond houses and mortgage guarantee companies that had issued real estate securities during the 1920s failed during the early 1930s. From this point on investors holding these securities went through complicated and protracted proceedings in order to liquidate the underlying mortgage assets. Some of these resolutions took more than a decade during which State authorities had to act as receivers and modifications of State and Federal law were required to help resolve conflicts among the parties who owned the loans. The failures of these securitization structures were so widespread, complex, and costly that private mortgage insurance and privately sponsored securitization disappeared entirely from the U.S. residential mortgage market for decades.

As we have seen earlier, the prospects for a covered residential mortgage bond system in the U.S. also diminished severely in the 1930s. But traditional portfolio mortgage lenders sought and received several regulatory interventions during the decade that strengthened their mortgage lending operations. The Building & Loan industry, which had been the Nation's largest source of home mortgages before 1930, was transformed into the modern Savings & Loan sector with the creation of the Federal Home Loan Bank System's discounting facility in 1932, a new system of Federal S&L charters, and an insurance program for S&L share accounts. A second important development was the creation in 1934 of the FHA mortgage loan insurance program that was discussed above. Although the companion covered mortgage bond system authorized by the legislation never materialized, FHA loans became important to the lending activities of mortgage companies, commercial banks, mutual savings banks and life insurance companies—none of which participated in the FHLB system. After the Federal National Mortgage Association was established to serve as a dedicated secondary market facility for FHA loans in 1938, therefore, all of the traditional mortgage portfolio lenders were supported by new Federal structures.

Traditional portfolio lenders performed well within their new Federal structures during the immediate post-World War II period. The S&L industry focused on local mortgage markets and small-scale builders; commercial banks and mortgage companies used FHA and VA loans to finance large tract builders and multifamily projects; and life insurance companies and mutual savings banks used insured and guaranteed loans to serve the interregional residential mortgage market through networks of closely affiliated mortgage companies. With all of this activity supported by the FHLB and FNMA secondary market facilities, the share of the Nation's residential mortgage debt that was held by the portfolio lenders swelled to 80 percent and financed a historic surge in homebuilding and homeownership during the 1950s and early 1960s (*See,* Figure 1).

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[13] *See,* Goetzmann and Newman (2010) and Snowden (2010a) for discussions of both instruments.

[14] HOLC is currently drawing substantial attention in the academic literature. *See,* Fishback *et al.* (2010), Rose (2010), and Courtemanche and Snowden (2010).

Despite the accomplishments, there were several disadvantages associated with relying so heavily on portfolio lenders. Strict regulatory boundaries, for example, limited competition and discouraged innovation. The more telling weakness, however, was the inability of portfolio lenders to profitably underwrite the risks of funding long-term, fixed-rate mortgages when nominal interest rates, driven by inflation, became variable around high levels in the 1970s. Institutions that relied on short-run deposits were particularly vulnerable, but even the life insurance companies, which had been successful farm and residential mortgage lenders for more than a century, dramatically reduced their portfolio of residential mortgage loans. It took more than a decade, and a full-blown thrift crisis, for the depression-era S&L industry to do the same.

Securitization reappeared in the U.S. in the 1970s to supplant the failing mortgage system that had been forged during the 1930s mortgage crisis. Securitization was not sponsored this time by private entities, as it had been in the 1920s, but by a Federal agency (Ginnie Mae) and federally sponsored GSEs (Fannie Mae and Freddie Mac) that had been carved out of the FHLB and FNMA secondary market facilities that had been created four decades earlier to support portfolio lenders. Agency- and GSE-sponsored securitization made modest inroads at first, but captured virtually all of the mortgage business lost by insurance companies and savings institutions during the 1980s.

During this period private agencies began to repackage the cash-flows from federally sponsored mortgage securities in order to offer investors other securities that offered different exposures to the prepayment and interest rate risks that had proven to be so troublesome for portfolio lenders. The trajectory and composition of securitization then changed in the 1990s, however, as the GSEs began to hold large volumes of mortgages and securities within their own portfolios, and private issuers began to securitize mortgage pools that contained the types of loans that the GSEs, at least at first, would not. We continue to debate the role that the GSEs played in our recent crisis, and changes in their structure and mission are sure to play a decisive role in the future development of the residential mortgage market.

But the topic of this hearing is the potential role that covered bonds will play in the future, and the chronology we have just reviewed reveals some striking similarities between the decisions Congress faces now and the ones that it confronted in the 1930s. Then, like now, it was responding to a mortgage crisis which had brought into focus severe problems with the private securitization structures that had grown so rapidly in the previous decade. Then, like now, it considered establishing a covered mortgage bond market to serve as a new funding channel for a housing market in distress. The legislation authorizing a covered mortgage bond system passed in the 1930s, but the system failed to materialize. What followed is the pattern of development and chain of events that has brought us here today. I hope that recounting this history provides some assistance to the Committee as it helps to shape the next chapter.

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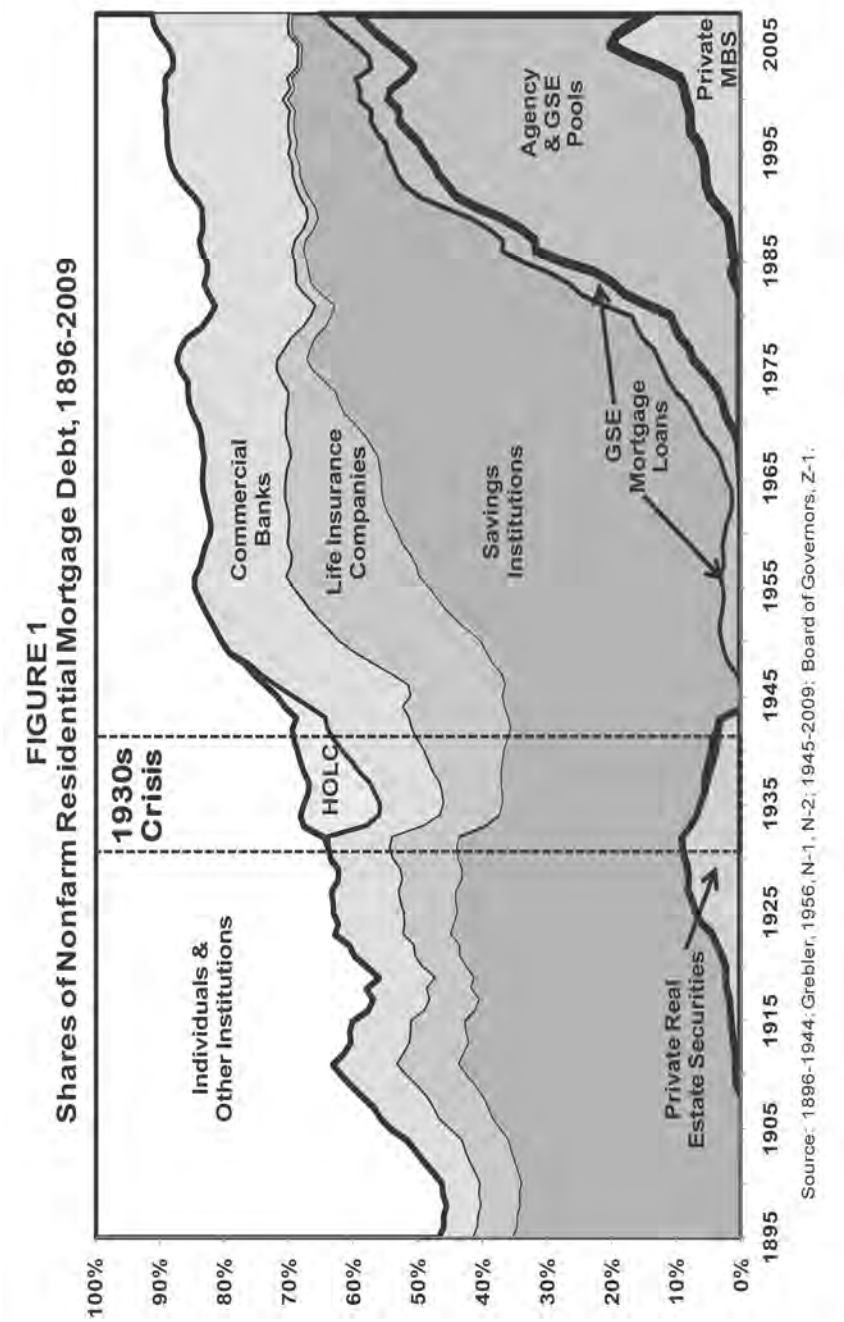


FIGURE 1
Shares of Nonfarm Residential Mortgage Debt, 1896-2009
1930s Crisis
Individuals & Other Institutions
Commercial Banks
HOLC
Life Insurance Companies
Savings Institutions
GSE Mortgage Loans
Agency & GSE Pools
Private MBS
Private Real Estate Securities
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
1895
1905
1915
1925
1935
1945
1955
1965
1975
1985
1995
2005
Source: 1896-1944: Grebler, 1956, N-1, N-2; 1945-2009: Board of Governors, Z-1.

PREPARED STATEMENT OF RIC CAMPO

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CAMDEN PROPERTY TRUST, ON BEHALF OF NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

SEPTEMBER 15, 2010

Chairman Dodd, Ranking Member Shelby, and distinguished Members of the Committee, I am Ric Campo, Chairman and CEO of Camden Property Trust, a publicly held apartment firm.

I am the immediate past Chairman of the National Multi Housing Council (NMHC) and am testifying today on behalf of NMHC and its joint legislative partner, the National Apartment Association (NAA).

Camden Property Trust is an S&P 400 Company and one of the largest publicly traded multifamily companies in the United States. Structured as a Real Estate Investment Trust (REIT), our company owns, develops, acquires and manages multifamily residential apartment communities. We are headquartered in Houston, TX, and currently operate 187 properties containing 64,074 apartment homes. Our workforce totals nearly 1,800 employees.

NMHC and NAA represent the Nation's leading apartment firms. Our combined memberships are engaged in all aspects of the industry, including ownership, development, management and finance. NMHC represents the principal officers of the industry's largest and most prominent firms. NAA is the largest national federation of State and local apartment associations with 170 State and local affiliates comprised of more than 50,000 members. Together they represent just under 6 million apartment homes.

We applaud the Senate Banking Committee for exploring alternative sources of capital to support housing. We believe that covered bonds could indeed provide some degree of additional liquidity to U.S. multifamily finance. We caution, however, that it is quite unlikely that covered bonds could provide the capacity, flexibility or pricing superiority necessary to adequately replace any of the U.S.'s traditional sources of multifamily mortgage credit.

I am not here today as an expert on covered bonds. Rather, I am hoping to provide you with some background on the apartment sector, its general credit needs and to share some insights into what role covered bonds could play in meeting those needs.

To understand the role or impact covered bonds might have on the apartment industry's access to credit, it is necessary first to have a broad understanding of the apartment industry's current capital sources—both before and during the crisis.

One-third of American households rent, and over 14 percent of households—16.7 million households—live in a rental apartment (buildings with five or more units). Our industry's ability to meet the Nation's rental housing needs depends on reliable and sufficient sources of capital.

Multifamily Capital Markets and Industry Performance

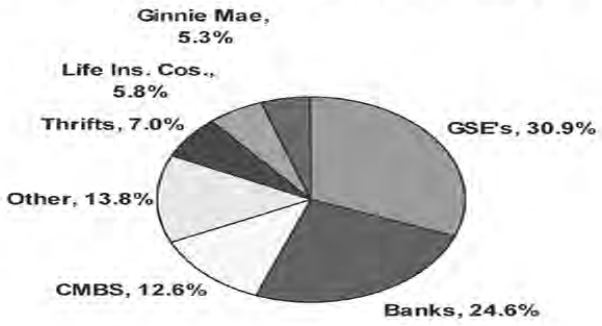
Since the onset of the financial meltdown, virtually all private mortgage lenders left the housing finance market, and the apartment industry has relied heavily on credit either insured or guaranteed by the Federal Government. Fully 8 out of 10 apartment loans issued in the first six months of 2010 had some form of Government credit behind them, namely FHA, Fannie Mae, or Freddie Mac. The FHA and Government Sponsored Enterprises (GSEs) are expected to account for 80–90 percent of the $50–$60 billion in credit provided to the apartment sector this year.

Historically, however, the apartment industry has enjoyed access to mortgage credit from a variety of capital sources. In addition to the FHA and GSEs, banks and thrifts, life insurance companies, pension funds and the commercial mortgage-backed securities market have all provided significant amounts of mortgage capital to the apartment industry. Prior to the financial crisis, these capital sources provided our sector with $100–$150 billion annually, reaching as high as $225 billion, to develop, refinance, purchase, renovate, and preserve apartment properties.

These market sources have proven to be reliable and durable, with the exception of unique financial situations, such as the current economic crisis and the 1997–1998 Russian financial crisis.

As of the first quarter of 2010, there was approximately $872 billion in outstanding multifamily mortgage debt (*See,* Table 1). In recent years, the industry has shifted from relying on whole loans from banks and life insurance companies to securitized loans. Currently, just under half (49 percent) of outstanding multifamily capital is held in the secondary market (31 percent by the GSEs, 13 percent in CMBS and 5 percent in Ginnie Mae.) Nevertheless, banks remain an important capital source, providing nearly one-quarter of the industry's mortgage capital.

Table 1
Multifamily Mortgage Debt Outstanding 2010 Q1

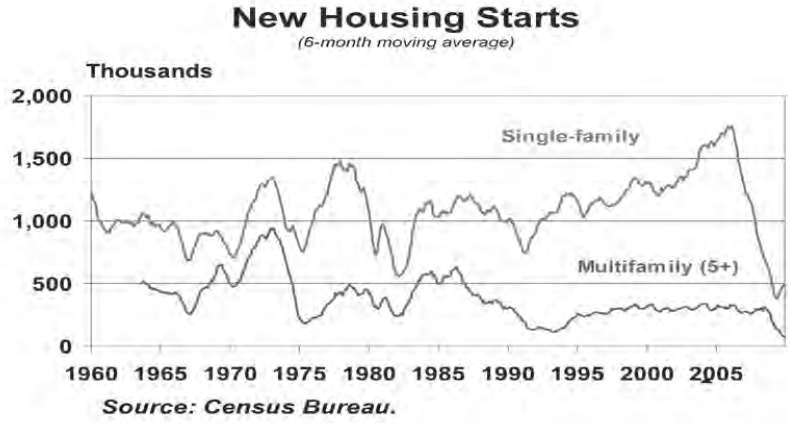


Source: Federal Reserve Outstanding Mortgage Debt 2010

As policy makers consider the causes of, and solutions to, the single-family meltdown, it is important to distinguish between performance in the single-family sector and the multifamily sector. The multifamily industry did not overbuild in the housing boom.

Table 2 below shows the stark contrast between the single-family housing production/bubble and resulting housing crisis and the relatively constant level of new production in the multifamily housing sector during the same period. Since the mid-1990s, the multifamily industry has started approximately 350,000–375,000 new units annually. During the same period, the single-family market almost doubled its production from around 1 million to 1.75 million units.

Table 2



The discipline shown by the apartment industry has translated into stronger portfolio performance as well. Overall loan performance in the $853 billion multifamily sector remains relatively healthy, with delinquencies and default rates only a fraction of those seen in single-family. The 90-day delinquency rate of multifamily loans is estimated to be 4.3 percent or $31 billion. Compared to the single-family residential mortgage market where the mortgage debt outstanding is reported at $10.7 tril-

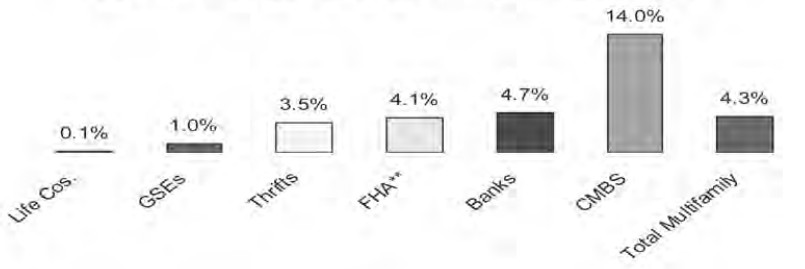
lion as of March 30, 2010, and a 90-day delinquency rate of 9.2 percent or $984.4 billion.

There has been some stress recorded in bank loans and CMBS, particularly those originated between 2006 and 2008 when more aggressive underwriting and higher leverage was employed. However, that stress is largely a result of the overall economy and the worst job market in 40 years and not due to oversupply.

Many of those problematic loans were taken out to renovate and reposition existing properties. When property values plummeted and unemployment soared, those projects stalled and borrowers lost most of their equity. The problem is especially acute in some markets such as the boroughs of New York City and other major employment centers that have large concentrations of apartment properties.

Nevertheless, many of these distressed loans will be resolved, and most apartment residents will not be affected by loan delinquencies or even defaults, as such situations generally result in a smooth transition to a new operating entity with sufficient capital to maintain the property.

Table 3
Delinquency Rates of Multifamily Credit Sources



Seriously delinquent loans are defined as at least 90 days past due and defaulted FHA multifamily Section 221(d)(4) loans.

Sources: Federal Reserve Outstanding Multifamily Mortgage Debt, 2010 Q1, Fannie Mae, Freddie Mac 10K/10Q SEC Filing Statements, and HUD.

** Data provided for the Federal Housing Administration multifamily portfolio is restricted to market rate Section 221(d)(4) defaulted loans as of July 2010, that total $505 million in defaulted loans. It does not include the full portfolio of multifamily insured loans including hospitals and nursing homes.

Covered Bonds and the Multifamily Credit Market

The current housing finance system has worked extremely well in providing liquidity to the apartment sector in all economic climates. That said, we welcome Congressional efforts to create a framework for covered bonds so they may serve as an additional source of capital for apartments. We do not believe, though, as some have suggested, that covered bonds can resolve the current financial crisis or prevent future crises that might require Government intervention.

It is clear that covered bonds offer some advantages to issuers and investors. They give issuers access to lower-cost funding for mortgage and other asset-backed credit with more favorable risk-based capital requirements than whole loans held in their portfolio. For investors, they offer high credit quality, solid yield, low-risk and diversified investments. They also offer both issuer and investor the ability to substitute bond assets in the collateral pools if there is a problem with an individual loan or mortgage, thus reducing overall risk.

My comments focus on the value of covered bonds to multifamily borrowers. Under the right conditions and circumstances, covered bonds could serve as an added credit option for our sector by augmenting banks' mortgage credit activity. Therefore, we support efforts to create the legal and regulatory oversight needed to foster the use of covered bonds by banks.

For numerous reasons, though, it is quite unlikely that covered bonds could provide the capacity, flexibility or pricing superiority necessary to adequately replace the U.S.'s existing sources of multifamily mortgage credit.

It is unclear whether covered bonds would actually increase the amount of credit banks would make available to apartment firms. The covered-bond structure limits issuer lending volumes by requiring them to hold loans on the issuer's balance sheet and retain capital reserves in case of losses. It is also possible that banks could simply replace some of their whole loans activities with covered bonds, which would not

increase lending capacity except as it relates to how risk-based capital reserves are held by banks.

Covered bonds could allow banks to compete with other credit sources such as life companies, thrifts, CMBS and GSEs because the loan term for covered bonds is longer (10-year terms) than the 5-year term banks typically provide. Even then, however, larger banks that are anticipated to be a major source of covered-bond issuance may choose not to issue covered loans for multifamily mortgages because many of these banks originate such mortgages for the GSEs or CMBS market and thereby avoid any balance sheet liability.

It is also unclear to what extent banks would use covered bonds for multifamily lending since so many asset classes qualify for covered bonds. Legislation pending in the House of Representatives (H.R. 5823, "The United States Covered Bond Act of 2010") would allow covered bonds to be used for single-family mortgages and equity loans, commercial and multifamily real estate mortgages, auto loans and leases, loans for public facilities and activities, student loans, small business loans and credit card and revolving credit loans to consumers. We question the capacity of covered bonds to meet the demand from all of these loan categories.

In Europe, the majority of real estate-related covered-bond debt has been for public purposes and residential home mortgages. Unless there are allocations and diversification requirements for covered-bond issuers, we expect the U.S. experience would be similar, with most of the additional credit created by covered bonds directed to the residential mortgage market and other consumer and loan assets and not toward rental housing.

It is also important to understand that the European experience with covered bonds for multifamily properties is not translatable to the U.S. In Europe, the rental markets operate on a condominium model comprised of small investors buying individual units and renting them out. For instance, in the United Kingdom, 73 percent of the rental stock is owned by "mom-and-pop" operators, and there is no institutional investment. There is little existing data or analysis determining to what degree European covered bonds actually finance commercially developed rental housing.

In addition to these issues, it also remains unclear whether the covered-bond structure can become sufficiently flexible to accommodate broad-based, public-sector participation in the U.S. affordable-housing finance arena. For instance, a significant proportion of apartment production in recent decades has been financed through Low-Income Housing Tax Credit (LIHTC) equity investments and various structures of tax-exempt or otherwise subsidized bonded debt. These specialized loans may not be able to gain access to covered-bond credit capital.

Likewise, questions remain about whether a purely private American covered-bond market could become a critical "backstop" capital source during periods of financial instability. While Europe's covered-bond market came to something of a standstill during the global financial crisis, in the U.S. the GSEs, Fannie Mae and Freddie Mac, remained a critical liquidity source in the domestic multifamily finance field. They have served this role during other capital market dislocations, including the Russian economic collapse in the late 1990s, which caused a collapse of the U.S. commercial mortgage conduit market, and during the 2001–2003 recession.

Although the European covered-bond market remained liquid longer than many other wholesale funding markets, it was ultimately rendered dormant for several months during the last quarter of 2008. In the wake of Lehman Brothers' collapse in September 2008, the European covered-bond market went without a public issuance until early 2009 and some jurisdictions have still not seen new issuance. The European Central Bank (ECB) reported earlier this year that the number of issuers has doubled since 2008 (from approximately 75 to 150 issuers).[1] But this was fueled in large part by ECB-sponsored bond purchase programs to facilitate liquidity.

Despite some €60 billion ($76.6 billion) in ECB-sponsored purchase commitments, however, the return of liquidity appears to be limited. Covered bonds over the past few calendar quarters have traded at historically low volumes and at historically wide yield spreads over their relevant benchmarks.

For all these reasons, we can only conclude that a covered-bond market might augment—but would not adequately replace—any of the active components of the U.S. multifamily finance marketplace, including "conduit" financing through mortgage-backed securities issued by the GSEs and private Wall Street firms, along with mortgages funded by life companies, banks and other balance sheet lenders.

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[1] European Central Bank Annual Report, p. 19.

Maintaining Credit Capacity for the Apartment Market

The bursting of the housing bubble exposed serious flaws in our housing finance system. As policy makers undertake housing finance reform—including creating a framework for a U.S. covered-bonds market—we urge you to ensure that any actions taken are not done so at the expense of the much smaller and less understood, but vital, multifamily sector.

Apartments are a critical component of the Nation's housing market, and our industry depends on a reliable, reasonably priced and readily available supply of credit to meet the Nation's growing demand for rental housing.

The U.S. is on the cusp of fundamental changes in our housing dynamics. Changing demographics are causing a surge in rental demand that will continue long after the economic recovery. This includes 78 million echo boomers entering the housing market, baby boomers downsizing and a dramatic decrease in the number of married couples with children to less than 22 percent of households.

Between 2008 and 2015, nearly two-thirds of new households formed will be renters. That's 6 million new renter households. University of Utah Professor Arthur C. Nelson predicts that half of all new homes built between 2005 and 2030 will have to be rental units. The Harvard University Joint Center for Housing Studies estimates that we already have a shortage of some three million units of affordable rental housing.

Our industry cannot meet the Nation's current or future housing needs—or refinance the approximately $200 billion in mortgage debt coming due over the next 2 years—without a fully functioning secondary mortgage market.

For these reasons it is critically important to maintain the existing level of liquidity for the multifamily market, in good times and bad. The strong performance of the sector, thanks in large part to the robust capital markets supporting it, has attracted an enormous amount of private investment. These investors have supported the expansion of the industry and a marked improvement in its professionalism. It has made the production of millions of units of workforce and market-rate housing possible.

For the past 50 years, the U.S. housing system has been the envy of the world in attracting private capital to meet our Nation's housing needs. As lawmakers look for added mortgage credit sources and redesign the secondary mortgage market, we urge them to retain the successful elements of our present system, specifically those which contributed to the strength of the multifamily market, and understand the inherent limitations of new capital sources, such as covered bonds.

Tomorrow's Housing Policy: New Principles

I would also like to take a moment to address our national housing policy more broadly, as I feel that it underscores the importance of explicitly considering apartments in a reformed housing finance system.

For decades, the Federal Government has pursued a "homeownership at any cost" housing policy, ignoring the growing disconnect between the country's housing needs and its housing policy. In the process, many people were enticed into houses they could not afford, which in turn helped fuel a housing bubble that ultimately burst and caused a global economic crisis.

The Nation is now paying the price for that misguided policy and learning firsthand that there is such a thing as too much homeownership; that aggressively pushing homeownership was not only disastrous for the hardworking families lured into unsustainable ownership, but also for our local communities and our national economy.

If there is a silver lining in this situation, it is the opportunity we now have to learn from our mistakes and rethink our housing policy. Housing our diverse Nation means having a vibrant rental market along with a functioning ownership market. It's time we adopt a balanced housing policy that doesn't measure success solely by how much homeownership there is.

For many of America's most pressing challenges, from suburban sprawl to affordable housing, apartments are a much better solution. Apartments help create stronger and healthier communities by offering enough housing for the workers that businesses need, by reducing the cost of providing public services like water, sewer, and roads and by creating vibrant live/work/play neighborhoods.

They will help us house our booming population without giving up all our green space and adding to pollution and traffic congestion. And they will help us reduce our greenhouse gas emissions by creating more compact communities that enable us to spend less time in our cars.

Elements of a Balanced Housing Policy

NMHC and NAA have joined together to advocate for a more balanced housing policy, one that respects the rights of individuals to choose housing that best meets their financial and lifestyle needs. We urge policy makers at all levels of Government to work with the apartment industry to craft a smarter housing policy that:

- Assures that everyone has access to decent and affordable housing, regardless of his or her housing choice;
- Respects the rights of individuals to choose the housing that best meets their financial and lifestyle needs without disadvantaging, financially or otherwise, those who choose apartment living;
- Promotes healthy and livable communities by encouraging responsible land use and promoting the production of all types of housing;
- Recognizes that all decent housing, including apartments, and all citizens, including renters, make positive economic, political and social contributions to their communities; and
- Balances the expected benefits of regulations with their costs to minimize the impact on housing affordability.

In conclusion, our industry stands ready to meet the Nation's growing demand for rental housing. We would encourage lawmakers to support us in those efforts by helping to craft a more balanced housing policy and by ensuring that housing finance reform efforts do not have an adverse effect on the apartment sector given that the sector was not responsible for the meltdown and has a long track record of strong performance.

Attachment: NMHC Analysis: Credit Capacity of Covered Bonds, July 2010

NMHC National Multi Housing Council®
Apartments: Smart Communities, Smarter Living

NAA National Apartment Association

WHITE PAPER

NMHC/NAA Joint Legislative Program • Suite 540 • 1850 M Street, NW • Washington, DC 20036 • (202) 974-2300 • Fax (202) 775-0112 • www.nmhc.org

June 30, 2010

Key Contact:

David Cardwell
VP of Capital Markets and Technology
dcardwell@nmhc.org

Lauren Dwyer
Director of Technology and Industry Initiatives
ldwyer@nmhc.org

Other NMHC/NAA Staff Contacts:

Douglas M. Bibby
President
dbibby@nmhc.org

James N. Arbury
Senior VP of Government Affairs
jarbury@nmhc.org

Elizabeth (Betsy) Feigin Befus
VP, Employment Policy and Counsel
ebefus@nmhc.org

Matthew Berger
VP, Tax
mberger@nmhc.org

Lisa E. Blackwell
VP, Housing Policy
lblackwell@nmhc.org

Jeanne McGlynn Delgado
VP, Business and Risk Management Policy
jdelgado@nmhc.org

Kimberly D. Duty
VP, Communications
kduty@nmhc.org

Eileen C. Lee, Ph.D.
VP, Environment
elee@nmhc.org

Ronald G. Nickson
VP, Building Codes
mickson@nmhc.org

Mark H. Obrinsky, Ph.D.
VP, Research and Chief Economist
mobrinsky@nmhc.org

Analysis: Credit Capacity of Covered Bonds

- Covered bonds are similar to asset-backed securities, but some differences improve security for the bond buyer. The underlying security interests remain on the balance sheet of the issuing bank, and bondholders retain security interests even if the issuer becomes insolvent.
- Covered bonds are a $3 trillion marketplace in Europe, and some suggest that they should be used in American multifamily finance as well.
- This white paper gives background on covered bonds and provides a framework for understanding the risks, benefits and limitations inherent in establishing a similar market in the United States.
- NMHC/NAA's conclusion: A prospective U.S. covered bond market should not be considered an alternative or a replacement for, but rather a supplement to, the current secondary multifamily mortgage system and the GSEs.

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About the National Multi Housing Council

For more than 30 years, the National Multi Housing Council (NMHC) has provided strategic leadership to the apartment industry. Through its highly effective government affairs program, its business guidance and re-search reports, and its sought-after industry meetings, NMHC has developed a reputation as the apartment executive s best ally.

Based in Washington, DC, NMHC represents the largest and most prominent firms in the apartment industry, in-cluding owners, developers, managers, lenders and brokers. The Council benefits from a focused agenda and a membership that includes the principal officers of the most distinguished real estate organizations in the United States. With its joint legislative partner, the National Apartment Association, NMHC serves as the apartment in-dustry s primary advocate on legislative and regulatory matters, such as housing policy, finance, tax, technology, property management, environmental issues and building codes.

In addition to providing leadership on public policy issues, NMHC is acknowledged as the preeminent source of apartment-related information. The Council is committed to expanding the scope of industry research by con-ducting and sponsoring research on such critical issues as apartment market conditions, resident demo-graphics, owning versus renting, industry structure and the impact of policy on market supply and demand. For more in-formation on joining NMHC, contact the Council at 202/974-2300 or visit www.nmhc.org.

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EXECUTIVE SUMMARY

In response to the financial crisis and its severe impact on the U.S. residential and commercial/multifamily mortgage markets, some observers have suggested establishing a covered bond market similar to the European model as a means of improving liquidity in the real estate finance arena.

A careful analysis concludes that a thriving domestic covered bond market might indeed provide some additional liquidity to the mortgage marketplace. However the analysis also reveals that efforts to comprehensively replace prevailing multifamily mortgage financing mechanisms with a covered bond system would provide limited benefits at best.

Most notably it doesn t appear a covered bond marketplace would offer the flexibility and variety of loan structures, terms and rates that U.S. multifamily and commercial borrowers demand. Nor would it likely boost liquidity by a truly significant extent, given the need for bond issuers to retain the underlying mortgages on their balance sheets.

The European experience indicates that covered bonds, as a secondary-market mortgage financing mechanism, do indeed provide numerous benefits to various participating parties. Investors earn attractive risk-adjusted yields on instruments featuring low-risk -second recourse" security. Financial institutions that issue the bonds benefit from attractively priced funds and reduced risk-based capital requirements, along with meaningful collateral substitution capabilities.

These characteristics can combine to minimize borrowing costs to multifamily and commercial property borrowers. And any additional liquidity a covered bond market generates would boost the market s overall lending capacity.

But again for numerous reasons this report will detail, it is quite unlikely covered bonds could provide the capacity, flexibility or pricing superiority necessary to adequately replace the U.S. s existing sources of multifamily mortgage credit.

Among the most significant:

- In contrast to U.S. commercial mortgage lenders broad flexibility with respect to term and rate structures, the covered bond market is characterized as far more uniform and commoditized;
- In contrast to the U.S. s generally thriving secondary mortgage markets, which allow originating lenders to remove loans from their balance sheets, the covered bond structure limits issuer lending volumes by requiring them to hold loans in portfolios and retain capital reserves in case of losses;
- In contrast to European markets, life insurers and other active U.S. apartment mortgage lenders would compete aggressively with covered bond issuers with regard to interest rates and loan terms;
- In contrast to the short-term lengths and consequential -balloon" repayment requirements associated with covered bonds, American apartment investors are accustomed to a variety of term choices including 10-year balloon loans and longer-term fully amortizing structures; and
- In contrast to covered bond issuers prohibitions (or extreme limitations) of additional financing subordinate to first-priority mortgage debt, U.S. borrowers have seen lenders compete by allowing various secondary financing structures.

In addition to these issues, it also remains unclear whether the covered bond structure can become sufficiently flexible to accommodate broad-based public-sector participation in the U.S. affordable-housing finance arena. For instance a significant proportion of apartment production in recent decades has been financed through Low-

Income Housing Tax Credit (LIHTC) equity investments, and various structures of tax-exempt or otherwise subsidized bonded debt.

Likewise questions remain about whether a purely private American covered bond market could become a critical -back-stop- capital source during periods of financial instability. While Europe's covered bond market came to something of a standstill during the global financial crisis, the U.S. government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac remained a critical liquidity source in the domestic multifamily finance field.

Nor does the evidence suggest a covered bond market would provide more attractive multifamily borrowing rates and terms, nor any greater financial security to American taxpayers.

For all these reasons, our analysis can only conclude that a covered bond market might augment – but would not adequately replace – any of the active components of the U.S. multifamily finance marketplace, including -conduit- financing through mortgage-backed securities issued by the GSEs and private Wall Street firms, along with mortgages funded by life companies, banks and other balance-sheet lenders.

INTRODUCTION

This analysis provides background information on the nearly $3 trillion European covered bond marketplace, and assesses prospects for extending it into the U.S. multifamily finance arena. Its primary intent is to provide a framework for understanding the risks, benefits and limitations inherent in establishing a similar market in the United States.

In addition to defining covered bonds, their key features and market trends, this study details the history of the European covered bond market and discusses how this fully established market fared during the 2008 financial crisis.

In July of 2008, the U.S. Department of the Treasury, in cooperation with numerous large banks, announced that Treasury would begin establishing regulations aimed at jump-starting a covered bond market in the U.S. The purpose of the initiative was communicated as a means to provide an alternative form of residential mortgage-backed securities.

Several regulatory agencies have been promoting the covered bond model in an effort to increase availability, and lower the cost of mortgage financing, to accelerate the return of normal home buying and refinancing activity,- as former Treasury Secretary Henry M. Paulson put it.

DEFINING COVERED BONDS

In recent years, covered bonds have become the dominant source of residential mortgage credit in Europe. Some countries there even look to covered bonds to help finance public infrastructure development. They have also been used to finance ships.

Covered bonds are similar in many ways to asset-backed securities, but some noteworthy differences improve bond buyer security and hence attract a broader investor base. Most notably, underlying security interests in the cover pool of mortgage loans remain on the balance sheet of the issuing bank – and bondholders retain security interests in the cover pool even if the issuer becomes insolvent.

Accordingly, covered bonds eliminate risks associated with mortgage-derived cash flows because principal and interest are paid by bond issuers. The mortgages in the cover pool, which are controlled by the issuer, serve only as collateral for investors rather than the source of cash flow necessary to ensure interest and principal payments.[1]

[1] European Covered Bond Council Fact Book (2009), p. 325-335.

The collateral risk may likewise be lower than with typical mortgage-backed securities due to asset substitution rules and other factors. But issuing banks must nevertheless reserve against potential losses associated with mortgage loans.

In contrast, mortgage- and other asset-backed securities are typically off-balance-sheet transactions. Lenders sell loans to special purpose vehicles (SPV) that issue bonds, thereby removing the credits, along with their risks, from lenders balance sheets. Absent detection of fraud, investors have no recourse to banks that sell mortgages to SPVs.

Again, covered bond issuers ability to alter loan pools in order to maintain targeted credit quality is another important distinction, as it further protects bondholder interests. Issuers can also modify certain loan terms in order to boost credit quality. Collateral substitutions and loan modifications historically have not been allowed with securitized commercial mortgages in the U.S.

Nor do covered bonds entail material refinance risk, as underlying loans are typically leveraged no more than 80 percent - a rate securitized U.S. residential mortgages have often exceeded. And even if the issuing bank ultimately becomes insolvent, the assets in the cover pool are separated from the issuer s other assets solely for the benefit of the covered bondholders.

Based on the high quality of the loans in the cover pool, the strength of the issuing banks and other security characteristics, most covered bonds receive high credit ratings of double-A or triple-A. Bond maturities generally range from two to 10 years, although there has been a recent trend toward maturities beyond 10 years (but typically not more than 20), with amortization periods of 20 to 30 years.

European Regulatory Frameworks

Current regulations of covered bonds in the U.S. differ somewhat from those in Europe. For instance, 26 of 31 European nations where covered bonds are allowed (as of December 2007) treat them under "special law"-based regulatory frameworks, while a handful oversee them through "general law"-based frameworks.

Under special law frameworks, standardized uniform regulations more clearly detail legal rights of bond holders, including certain regulated investors that might benefit from preferential risk weightings.

Several key regulatory provisions are common to both legal frameworks:

- Bond are issued by - or bondholders otherwise have full recourse to - a lender (credit institution) subject to public supervision and regulation;
- Bondholders claims against pools of financial assets covered by the bonds are superior to the credit institutions unsecured creditors;
- The credit institution is obligated to maintain sufficient assets in the cover pool to satisfy the claims ol covered bondholders at all times; and
- The obligations of the credit institution with respect to the cover pool are supervised by public or other independent bodies.[2]

According to the European Covered Bond Council (ECBC), the market for these instruments would be much smaller absent the regulatory frameworks. The ECBC states that without the general-law and special-law based frameworks, the volume of issued and outstanding covered bonds would be approximately 25% of what has been seen to date.

[2] European Covered Bond Council Fact Book (2009), p. 96

Regulations of covered bonds issued in the U.S. provide for additional bond holder access to pledged collateral in the event issuing institutions are taken over by the Federal Deposit Insurance Corp. or another regulator. Among those provisions:

- Cover pool assets must consist primarily of home mortgages (up to 10% of assets can be AAA-rated MBS);
- Covered bonds can account for no more than 4% of an issuer s total liabilities; and
- The covered bond asset pool s value must remain equal to or greater than the bond issue s outstanding principal balance.

Key Benefits, Limitations

The fundamental benefit of covered bonds in theory is that they allow issuers to funnel bond sale proceeds into additional mortgage (and other) lending, while also providing investors with additional security protections not seen with traditional mortgage-backed securities. The other commonly noted benefits of covered bonds to investors include:

- Strong credit quality;
- Attractive yields suitable for conservative portfolios; and
- Exceptional security via the extra recourse layer upon issuer default.

Nevertheless, regulation and industry practices also create a number of less attractive characteristics that may well tend to limit the U.S. market for covered bonds. Among the most notable limitations:

- Holding covered bonds on issuer balance sheets limits issuance volume and in turn new loan originations;
- Consequences for bond holders when regulators absorb insolvent issuers aren t yet absolutely clear;
- Bond term lengths defining the European market won t necessarily satisfy U.S. investors;
- Loan underwriting practices in the European covered bond market may prove too conservative for U.S. borrowers;
- No track record to date validates the viability of using commercial mortgages and commercial MBS in cover pools, rather than using residential assets exclusively; and
- Competition from covered bonds could potentially limit participation of life insurance companies and private capital sources in multifamily mortgage funding.

It should be noted that uncertainty over regulatory practices in cases of issuer insolvency - particularly regarding bond holder rights to cover pool assets - is thought to be a primary factor in the limited track record of covered bond issuance in the U.S. That is, while issuance of covered bonds is not prohibited in the U.S., to date only two U.S. financial institutions have issued covered bonds.

Past, Current Use

Over decades and even centuries, covered bonds have evolved into a key capital markets component in nearly all European countries. These instruments date back two centuries to their origination as a means of agricultural financing. They subsequently evolved into public interest and government operations, followed by residential and commercial real estate financing markets.

Use of covered bonds declined somewhat in the 20th century as European inter-bank finance markets came to prominence. But then issuances increased again rapidly in the 1990s to meet investor demand for highly liquid

financial products. Covered bonds currently play an important role in the European financial system, and thereby contribute to the efficient allocation of capital and ultimately economic development and prosperity.

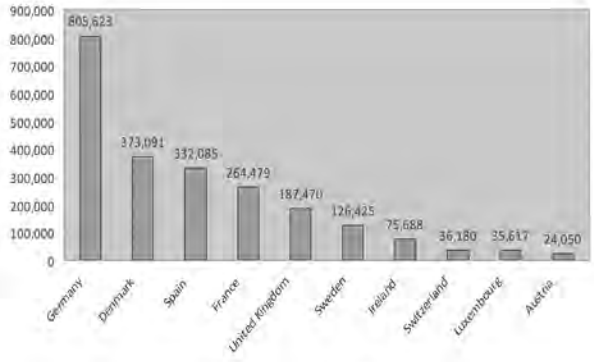
According to the most recent data available, covered bonds now equate to approximately 20% of outstanding residential mortgage debt in the European Union. The total principal outstanding at the end of 2008 amounted to 2.38 trillion ($2.84 trillion) worth of bonds covered by mortgage loans, public-sector loans and ship loans - up 12% from the year-earlier figure.[3]

Mortgage covered bonds continue to dominate the market, accounting for 78% of the gross supply and 64% of the outstanding volume of covered bonds at the end of 2008.[4] The five largest issuing countries in 2008 were Germany, Denmark, United Kingdom, France and Spain - with public-sector loans playing prominent roles in each.

Figure 1 shows the total volume of outstanding covered bonds by country for the fourth quarter of 2008 for the top 10 European countries. The U.S. ranked 15th of the 25 countries reportedly issuing covered bonds according to the ECBC, with a total outstanding volume of $15.4 billion in 2008.

In addition to the United States, other countries identified by ECBC but not depicted in this chart include: Norway, Netherlands, Portugal, Italy, Czech Republic, Hungary, Canada, Finland, Greece, Slovakia, Poland, Iceland, Latvia, and Ukraine. The combined outstanding principal of the top 10 issuing countries at the end of 2008 was 2.26 trillion ($2.7 trillion). The other 15 countries' combined outstanding volume at the end of 2008 totaled only 119.2 billion ($142.3 billion).[5]

Figure 1: Total Volume of Outstanding Covered Bonds (Top 10 European Countries)/Million



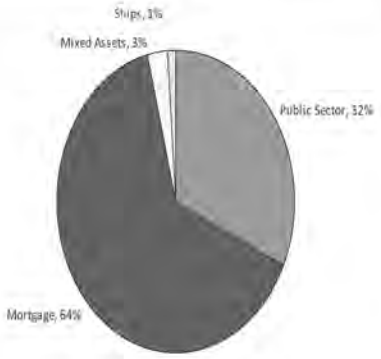
Source: European Covered Bond Council Fact Book (2009)

The major categories of covered bond assets are mortgage loans, public sector loans and ship loans. Regulators in each country specify the array of eligible cover pool assets. All European nations that allow covered bonds have activity in bonds backed by residential and commercial mortgages.

[3] European Covered Bond Council Fact Book (2009), p. 92.
[4] European Covered Bond Council Fact Book (2009), p. 93.
[5] European Covered Bond Council Fact Book (2009), p. 93.

Covered bonds issued to fund public sector lending play an important role in Germany, France, Ireland, Luxembourg, Austria, Italy and Spain. Covered bonds backed by ship loans are much less common, found mostly in Denmark and Germany.

Figure 2: Total Outstanding Covered Bonds by Asset Classification (European Market)



Source: European Covered Bond Council Fact Book (2009), p. 88.

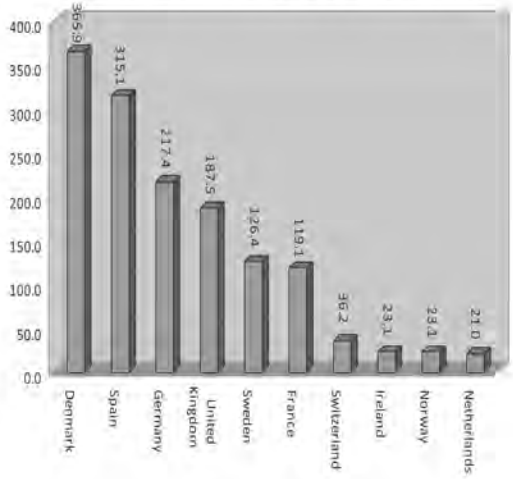
Mortgages are far and away the most heavily utilized classification among assets used as collateral for covered bonds issued throughout the European Union and the U.S. (see Figure 2). According to ECBC data, among the 25 countries currently issuing covered bonds (including the U.S.), 64% of outstanding issues are backed by mortgage collateral, and 32% are backed by public sector loans.

It s also informative to note that Germany alone accounts for -558 billion ($666 billion) of the approximately -773 billion ($923 billion) in outstanding covered bonds backed by public sector loans.[6] This indicates that use of mortgage collateral is even more widespread than the aggregate data alone might suggest.

Figure 3 shows the volume of covered bonds backed by mortgage assets for the top 10 issuing countries in Europe. Additionally the United States had a total of $15.4 billion in outstanding volume in 2008, all categorized as mortgage asset collateral, according to the ECBC.[7] Disbursement of covered bonds by category in the European Union outstanding at the end of 2008 is shown in Figure 4.

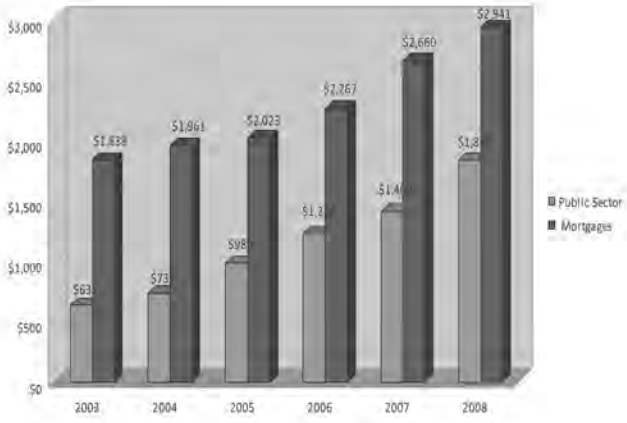
[6] European Covered Bond Council Fact Book (2009), p. 92-93.
[7] European Covered Bond Council Fact Book (2009), p. 92.

Figure 3: Total Volume of Covered Bonds Collateralized by Mortgage Assets (Euros/Billion)



Source: European Covered Bond Council Fact Book (2009), p. 92.

Figure 4: Total Covered Bonds Outstanding by Asset Class in Europe/Billion



Source: European Covered Bond Market Fact Book (2009), p. 88-92.

As for continued market expansion in Europe, the ECBC concludes: there is a strong expectation that the covered bond market will continue to grow, especially since legislators across Europe have adopted modern covered bond regulations or modernized existing ones-.[8]

U.S. Potential: Regulatory Framework

But just how well would the regulatory framework and other factors that have driven growth of the European covered bond market translate to U.S real estate capital markets? It's a difficult question to answer with any certainty, given that the European market has grown in part because Europe's borrowers and investors don't have access to American-style GSEs or Federal Home Loan Banks.

One way to approach that question is to consider key differences between covered bonds and the MBS marketplace that plays such a prominent role in U.S. commercial and multifamily finance. Our analysis identified four particularly significant differences between covered bonds and MBS as sources of long-term funding for mortgage loans:

- In the event the cover pool mortgages don't pay interest and principal as originally agreed, covered bonds provide investors with a second form of recourse, i.e., to the bond issuer. MBS do not provide this second form of recourse when borrowers are delinquent; bondholders simply face greater exposure to underlying real estate risks.

- European covered bond regulations allow an issuer to substitute collateral if some of the underlying mortgages default, under-perform or are prepaid; this helps maintain the cover pool's credit quality and in turn the bonds' ratings and values. U.S. REMIC- (real estate mortgage investment conduit) rules require static MBS collateral pools rather than allowing for collateral substitution; this means an issue's repayment risk fluctuates in correlation to the credit quality of the original mortgages.

- Covered bonds minimize the risk of prepayment in the event an issuer defaults prior to maturity, by way of an investment contract guaranteeing payments on the bonds from default through maturity. MBS investors assume prepayment risk potentially resulting from both mortgage defaults and prepayment.

- In a typical MBS transaction, the securities issuer no longer carries the underlying mortgages on its balance sheet – which frees up capital with which to make additional loans. In a covered bond transaction the collateralized mortgages remain as liabilities on the issuer's balance sheet – hindering the volume of new lending capabilities compared to a U.S.-style securitization.

Another means of assessing the extent to which covered bonds might play a prominent role in U.S. commercial/multifamily real estate finance is to review significant legal and regulatory issues pertaining to structure and use of covered bonds here. And while a couple of institutions have issued these securities, it's hard to avoid the conclusion that the regulatory framework today remains insufficient to support a thriving domestic covered bond market.

While legislation including covered bond regulation has been introduced, and relevant regulatory agencies have recommended frameworks, no current federal legislation or regulations clearly and unambiguously protect covered bond investor interests in the event of insolvency of an insured depository institution.

Nevertheless covered bonds generally are subject to some federal laws and regulations, including the Uniform Commercial Code (UCC), Rule 144A under the Securities Act, Regulation S under the Securities Act, and the Federal Deposit Insurance Act (FDIA).[9]

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[8] European Covered Bond Council Fact Book (2009), p. 92-93.
[9] European Covered Bond Council Fact Book (2009), p. 325-335.

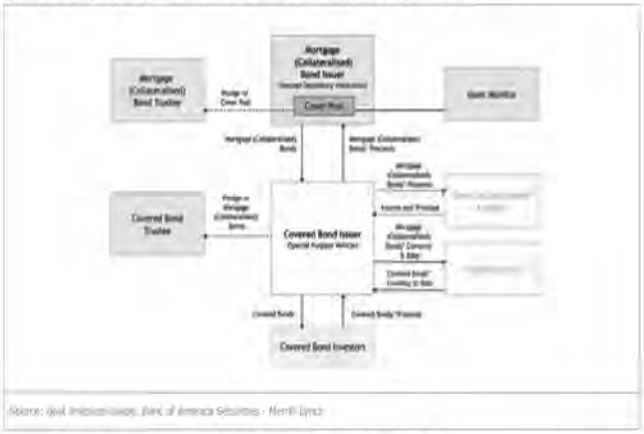
While more dedicated legislation has been under development (see below), covered bond issuance, including issues backed by mortgage collateral, has increased somewhat in recent years.

The U.S. Department of Treasury advocates establishing a definitive legislative and regulatory framework that would promote investor confidence and sound market integration. Treasury already provides a "Best Practices for Covered Bonds- guide encouraging domestic market development (see Appendix A).

The FDIC approved a final Covered Bond Policy Statement (Appendix B) clarifying the agency's position on qualifying covered bond transactions in July of 2008. The statement provides a common template to promote the development of a standardized covered bond market in the U.S.

Two large domestic financial institutions, Bank of America and the former Washington Mutual Bank (subsequently absorbed by JPMorgan Chase), have helped pioneer early U.S. covered bond issuances. These private-label issues aimed to comply with state laws of New York and Delaware. The general covered bond structure utilized by U.S. banks is depicted in Figure 5.

Figure 5: Simplified (SPV) Covered Bond Structure Currently Used by US Banks

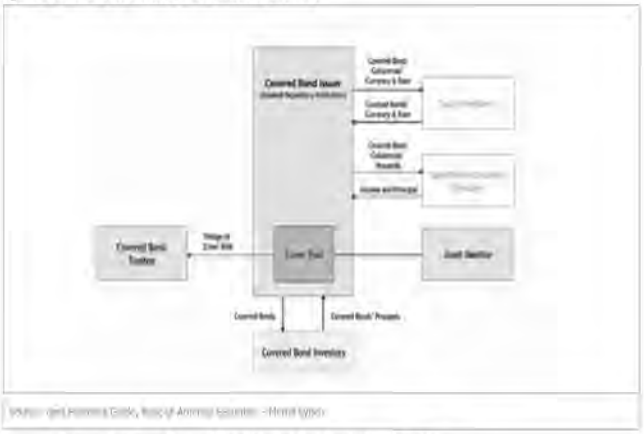


Source: European Covered Bond Market Fact Book (2009), p. 327.

Bank of America, Citigroup, JPMorgan Chase and Wells Fargo have announced their support for the two key statements addressing important U.S. policies regarding covered bonds. These institutions have also shown interest in setting up programs using the guidelines, or aligning existing covered bond programs to the standards under the final FDIC Covered Bond Policy Statement and the Treasury Department Best Practices Guide.

The structure proposed under this policy statement, and under consideration by those institutions, is depicted in Figure 6.

Figure 6: Potential US Covered Bond Issuance Structure



Source: European Covered Bond Market Fact Book (2009), p. 327.

Although some U.S. regulatory authorities have shown reluctance to establish dedicated covered bond regulations, the Treasury Secretary in early 2009 suggested such legislation should be considered in the context of broader housing finance reform efforts. Again, Treasury maintains that dedicated legislation clearly addressing investor interests in the event of issuer insolvency could help instill investor confidence in covered bonds.

Multiple legislative proposals have been introduced in an attempt to regulate the U.S. covered bond market. The most recent proposed legislation, The U.S. Covered Bond Act (H.R. 4884) aims to facilitate a covered bond market and provide a more comprehensive legislative framework than preceding bills.

The Act would establish regulatory oversight of covered bond markets, including broad provisions for default and insolvency of covered bond issuers, and would subject covered bonds to oversight by federal securities regulators. The legislation also directs the U.S. Securities and Exchange Commission to develop a registration process for covered bonds that are not exempt from SEC oversight.

Eligible asset classes under the proposed legislation include: residential mortgages, home equity loans, commercial mortgages, public agency debt, auto loans, student loans, credit card debt, small business loans, and other asset classes not yet identified by the regulator.[10]

Opponents of the legislation question whether a covered bond market would improve liquidity in the U.S. mortgage market. They also cite the additional bank failure risks to which covered bonds would subject the FDIC, along with the related hikes in FDIC deposit insurance rates. Proponents counter that H.R. 4884 is not intended to facilitate a U.S. covered bond market that would replace existing sources of finance, but instead aims to provide additional liquidity complementing other forms of mortgage funding.

Financial Crisis Impact

Though long considered a reliable and durable source of mortgage capital, the European covered bond market nevertheless suffered its share of distress during the latest global financial meltdown. It remained liquid longer

[10] Treasury Department Best Practices Guide for Covered Bonds, p. 9.

than many other wholesale funding markets, but was ultimately rendered dormant for several months during the last quarter of 2008.

In the wake of Lehman Brothers collapse in September 2008, the European covered bond market went without a public issuance until early 2009. Nevertheless, the market did record some positive growth over the course of 2008. While some European jurisdictions haven t seen new issues since then, the European Central Bank reports that the number of issuers has doubled since 2008 (from approximately 75 to 150 issuers).[11] Of course it helped that the European Central Bank (ECB) sponsored bond purchase programs to facilitate liquidity.

Despite some -60 billion in ECB-sponsored purchase commitments, however, the return of liquidity appears to be limited. Covered bonds over the past few calendar quarters have traded at historically low volumes and at historically wide yield spreads over their relevant benchmarks.

And now, in 2010, as the perplexing European debt crisis continues to unfold, the expectation is that efforts to resolve state fiscal issues will deflect interest in the covered bond market somewhat. Despite these challenges, new players continue entering the market, and existing issuers are able to expand programs, offer multiple products and diversify funding sources.

Conclusion

Based on NMHC s analysis, we conclude covered bonds would appeal to U.S. investors due to the generally strong credit quality of the underlying mortgages and real estate and the attractive yields they might generate without altering risk profiles of conservative portfolios. Covered bonds can also help diversify portfolios while protecting investors through the additional recourse they provide in the event of default.

Accordingly, it appears an active, unambiguously regulated covered bond marketplace would provide some degree of additional liquidity to the domestic multifamily finance arena.

However, based on the performance of the fully regulated and long-established covered bond market in Europe during the financial crisis of 2008, it is clear that this investment category has limitations. Likewise U.S. regulatory authorities have expressed concerns about a covered bond market s potential for increasing the risks that the FDIC or other agency might have to bear.

Therefore NMHC also concludes that a prospective U.S. covered bond market should not be considered an alternative or a replacement for, but rather a supplement to, the current secondary multifamily mortgage system and the GSEs.

[11] European Central Bank Annual Report, p. 19.

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APPENDIX A
FDIC POLICY STATEMENT

Allotments, Television Broadcast Stations (Riverside, California) (MB Docket No. 08–30).

Number of Petitions Filed: 1.

Subject: In the Matter of Improving Public Safety Communications in the 800 MHz Band (WT Docket No. 02–55). New 800 MHz Band Plan for U.S.-Canada Border Region.

Number of Petitions Filed: 1.

Marlene H. Dortch,

Secretary.

[FR Doc. E8–17276 Filed 7–25–08; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL DEPOSIT INSURANCE CORPORATION

Covered Bond Policy Statement

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Final Statement of Policy.

SUMMARY: The Federal Deposit Insurance Corporation (the FDIC) is publishing a final policy statement on the treatment of covered bonds in a conservatorship or receivership. This policy statement provides guidance on the availability of expedited access to collateral pledged for certain covered bonds after the FDIC decides whether to terminate or continue the transaction. Specifically, the policy statement clarifies how the FDIC will apply the consent requirements of section 11(e)(13)(C) of the Federal Deposit Insurance Act (FDIA) to such covered bonds to facilitate the prudent development of the U.S. covered bond market consistent with the FDIC's responsibilities as conservator or receiver for insured depository institutions (IDI). As the U.S. covered bond market develops, future modifications or amendments may be considered by the FDIC.

DATES: *Effective Date:* July 28, 2008.

FOR FURTHER INFORMATION CONTACT: Richard T. Aboussie, Associate General Counsel, Legal Division, (703) 562–2452; Michael H. Krimminger, Special Advisor for Policy, (202) 898–8950.

SUPPLEMENTARY INFORMATION:

I. Background

On April 23, 2008, the FDIC published the Interim Final Covered Bond Policy Statement for public comment. 73 FR 21949 (April 23, 2008). After carefully reviewing and considering all comments, the FDIC has adopted certain limited revisions and clarifications to the Interim Policy Statement (as discussed in Part II) in the Final Policy Statement.[1]

Currently, there are no statutory or regulatory prohibitions on the issuance of covered bonds by U.S. banks. Therefore, to reduce market uncertainty and clarify the application of the FDIC's statutory authorities for U.S. covered bond transactions, the FDIC issued an Interim Policy Statement to provide guidance on the availability of expedited access to collateral pledged for certain covered bonds by IDIs in a conservatorship or a receivership. As discussed below, under section 11(e)(13)(C) of the FDIA, any liquidation of collateral of an IDI placed into conservatorship or receivership requires the consent of the FDIC during the initial 45 days or 90 days after its appointment, respectively. Consequently, issuers of covered bonds have incurred additional costs from maintaining additional liquidity needed to insure continued payment on outstanding bonds if the FDIC as conservator or receiver fails to make payment or provide access to the pledged collateral during these periods after any decision by the FDIC to terminate the covered bond transaction. The Policy Statement does not impose any new obligations on the FDIC, as conservator or receiver, but does define the circumstances and the specific covered bond transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral.

Covered bonds are general, non-deposit obligation bonds of the issuing bank secured by a pledge of loans that remain on the bank's balance sheet. Covered bonds originated in Europe, where they are sub ect to extensive statutory and supervisory regulation designed to protect the interests of covered bond investors from the risks of insolvency of the issuing bank. By contrast, covered bonds are a relatively new innovation in the U.S. with only two issuers to date: Bank of America, N.A. and Washington Mutual. These initial U.S. covered bonds were issued in September 2006.

In the covered bond transactions initiated in the U.S. to date, an IDI sells mortgage bonds, secured by mortgages, to a trust or similar entity ("special purpose vehicle" or "SPV").[2] The pledged mortgages remain on the IDI's balance sheet, securing the IDI's obligation to make payments on the debt, and the SPV sells covered bonds, secured by the mortgage bonds, to investors. In the event of a default by the IDI, the mortgage bond trustee takes possession of the pledged mortgages and continues to make payments to the SPV to service the covered bonds. Proponents argue that covered bonds provide new and additional sources of liquidity and diversity to an institution's funding base.

The FDIC agrees that covered bonds may be a useful liquidity tool for IDIs as part of an overall prudent liquidity management framework and within the parameters set forth in the Policy Statement. While covered bonds, like other secured liabilities, could increase the costs to the deposit insurance fund in a receivership, these potential costs must be balanced with diversification of sources of liquidity and the benefits that accrue from additional on-balance sheet alternatives to securitization for financing mortgage lending. The Policy Statement seeks to balance these considerations by clarifying the conditions and circumstances under which the FDIC will grant automatic consent to access pledged covered bond collateral. The FDIC believes that the prudential limitations set forth in the Policy Statement permit the incremental development of the covered bond market, while allowing the FDIC, and other regulators, the opportunity to evaluate these transactions within the U.S. mortgage market. In fulfillment of its responsibilities as deposit insurer and receiver for failed IDIs, the FDIC will continue to review the development of the covered bond marketplace in the U.S. and abroad to gain further insight into the appropriate role of covered bonds in IDI funding and the U.S. mortgage market, and their potential consequences for the deposit insurance fund. (For ease of reference, throughout this discussion, when we refer to "covered bond obligation," we are referring to the part of the covered bond transaction comprising the IDI's debt obligation, whether to the SPV, mortgage bond trustee, or other parties; and "covered bond obligor" is the entity to which the IDI is indebted.)

Under the FDIA, when the FDIC is appointed conservator or receiver of an IDI, contracting parties cannot terminate agreements with the IDI because of the insolvency itself or the appointment of

[1] For ease of reference, the Interim Final Covered Bond Policy Statement, published on April 23, 2008, will be referred to as the Interim Policy Statement. The Final Covered Bond Policy Statement will be referred to as the Policy Statement.

[2] The FDIC understands that certain potential issuers may propose a different structure that does not involve the use of an SPV. The FDIC expresses no opinion about the appropriateness of SPV or so-called "direct issuance" covered bond structures, although both may comply with this Statement of Policy.

the conservator or receiver. In addition, contracting parties must obtain the FDIC's consent during the forty-five day period after appointment of FDIC as conservator, or during the ninety day period after appointment of FDIC as receiver before, among other things, terminating any contract or liquidating any collateral pledged for a secured transaction.[3] During this period, the FDIC must still comply with otherwise enforceable provisions of the contract. The FDIC also may terminate or repudiate any contract of the IDI within a reasonable time after the FDIC's appointment as conservator or receiver if the conservator or receiver determines that the agreement is burdensome and that the repudiation will promote the orderly administration of the IDI's affairs.[4]

As conservator or receiver for an IDI, the FDIC has three options in responding to a properly structured covered bond transaction of the IDI: (1) Continue to perform on the covered bond transaction under its terms; (2) pay off the covered bonds in cash up to the value of the pledged collateral; or (3) allow liquidation of the pledged collateral to pay off the covered bonds. If the FDIC adopts the first option, it would continue to make the covered bond payments as scheduled. The second or third options would be triggered if the FDIC repudiated the transaction or if a monetary default occurred. In both cases, the par value of the covered bonds plus interest accrued to the date of the appointment of the FDIC as conservator or receiver would be paid in full up to the value of the collateral. If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC, as conservator or receiver, for distribution as mandated by the FDIA. On the other hand, if there were insufficient collateral pledged to cover all valid claims by the secured parties, the amount of the claims in excess of the pledged collateral would be unsecured claims in the receivership.

While the FDIC can repudiate the underlying contract, and thereby terminate any continuing obligations under that contract, the FDIA prohibits the FDIC, as conservator or receiver from avoiding any legally enforceable or perfected security interest in the assets of the IDI unless the interest was taken in contemplation of the IDI's insolvency or with the intent to hinder, delay, or defraud the IDI or its creditors.[5] This statutory provision ensures protection for the valid claims of secured creditors up to the value of the pledged collateral. After a default or repudiation, the FDIC as conservator or receiver may either pay resulting damages in cash up to the value of the collateral or turn over the collateral to the secured party for liquidation. For example, if the conservator or receiver repudiated a covered bond transaction, as discussed in Part II below, it would pay damages limited to par value of the covered bonds and accrued interest up to the date of appointment of the conservator or receiver, if sufficient collateral was in the cover pool, or turn over the collateral for liquidation with the conservator or receiver recovering any proceeds in excess of those damages. In liquidating any collateral for a covered bond transaction, it would be essential that the secured party liquidate the collateral in a commercially reasonable and expeditious manner taking into account the then-existing market conditions.

As noted above, existing covered bond transactions by U.S. issuers have used SPVs. However, nothing in the Policy Statement requires the use of an SPV. Some questions have been posed about the treatment of a subsidiary or SPV after appointment of the FDIC as conservator or receiver. The FDIC applies well-defined standards to determine whether to treat such entities as "separate" from the IDI. If a subsidiary or SPV, in fact, has fulfilled all requirements for treatment as a "separate" entity under applicable law, the FDIC as conservator or receiver has not applied its statutory powers to the subsidiary's or SPV's contracts with third parties. While the determination of whether a subsidiary or SPV has been organized and maintained as a separate entity from the IDI must be determined based on the specific facts and circumstances, the standards for such decisions are set forth in generally applicable judicial decisions and in the FDIC's regulation governing subsidiaries of insured state banks, 12 CFR 362.4.

The requests to the FDIC for guidance have focused principally on the conditions under which the FDIC would grant consent to obtain collateral for a covered bond transaction before the expiration of the forty-five day period after appointment of a conservator or the ninety day period after appointment of a receiver. IDIs interested in issuing covered bonds have expressed concern that the requirement to seek the FDIC's consent before exercising on the collateral after a breach could interrupt payments to the covered bond obligee for as long as 90 days. IDIs can provide for additional liquidity or other hedges to accommodate this potential risk to the continuity of covered bond payments but at an additional cost to the transaction. Interested parties requested that the FDIC provide clarification about how FDIC would apply the consent requirement with respect to covered bonds. Accordingly, the FDIC has determined to issue this Final Covered Bond Policy Statement in order to provide covered bond issuers with final guidance on how the FDIC will treat covered bonds in a conservatorship or receivership.

II. Overview of the Comments

The FDIC received approximately 130 comment letters on the Interim Policy Statement; these included comments from national banks, Federal Home Loan Banks, industry groups and individuals.

Most commenters encouraged the FDIC to adopt the Policy Statement to clarify how the FDIC would treat covered bonds in the case of a conservatorship or receivership and, thereby, facilitate the development of the U.S. covered bond market. The more detailed comments focused on one or more of the following categories of issues: (1) The FDIC's discretion regarding covered bonds that do not comply with the Policy Statement; (2) application to covered bonds completed prior to the Policy Statement; (3) the limitation of the Policy Statement to covered bonds not exceeding 4 percent of liabilities; (4) the eligible collateral for the cover pools; (5) the measure of damages provided in the event of default or repudiation; (6) the covered bond term limit; and (7) federal home loan bank advances and assessments.

Certain banks and industry associations sought clarification about the treatment of covered bonds that do not comply with the Policy Statement by the FDIC as conservator or receiver. Specifically, commenters asked the FDIC to clarify that if a covered bond issuance is not in conformance with the Policy Statement, the FDIC retains discretion to grant consent prior to expiration of the 45 or 90 day period on a case-by-case basis. Under Section 11(e)(13)(C) of the FDIA, the exercise of any right or power to terminate, accelerate, declare a default, or otherwise affect any contract of the IDI, or to take possession of any property of the IDI, requires the consent of the conservator or receiver, as appropriate,

[3] See 12 U.S.C. 1821(e)(13)(C).

[4] See 12 U.S.C. 1821(e)(3) and (13). These provisions do not apply in the manner stated to "qualified financial contracts" as defined in Section 11(e) of the FDI Act. See 12 U.S.C. 1821(e)(8).

[5] See 12 U.S.C. 1821(e)(12).

during the 45-day period or 90-day period after the date of the appointment of the conservator or receiver, as applicable. By the statutory terms, the conservator or receiver retains the discretion to give consent on a case-by-case basis after evaluation by the FDIC upon the failure of the issuer.

Comments from banks who issued covered bonds prior to the Policy Statement requested either 'grandfathering' of preexisting covered bonds or an advance determination by the FDIC before any appointment of a conservator or receiver that specific preexisting covered bonds qualified under the Policy Statement. After carefully considering the comments, the FDIC has determined that to 'grandfather' or otherwise permit mortgages or other collateral that do not meet the specific requirements of the Policy Statement to support covered bonds would not promote stable and resilient covered bonds as encompassed within the Policy Statement. If preexisting covered bonds, and their collateral, otherwise qualify under the standards specified in the Policy Statement, those covered bonds would be eligible for the expedited access to collateral provided by the Policy Statement.

A number of commenters requested that the limitation of eligible covered bonds to no more than 4 percent of an IDI's total liabilities should be removed or increased. Commenters also noted that other countries applying a cap have based the limitation on assets, not liabilities. The Policy Statement applies to covered bond issuances that comprise no more than 4 percent of an institution's total liabilities since, in part, as the proportion of secured liabilities increases, the total unpledged assets available to satisfy the claims of uninsured depositors and other creditors from the Deposit Insurance Fund decrease. As a result, the FDIC must focus on the share of an IDI's liabilities that are secured by collateral and balance the additional potential losses in the failure of an IDI against the benefits of increased liquidity for open institutions. The 4 percent limitation under the Policy Statement is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market within the financial system of the United States, which differs in many respects from that in other countries deploying covered bonds. Consequently, while changes may be considered to this limitation as the covered bond market develops, the FDIC has decided not to make any change at this time.

A number of commenters sought expansion of the mortgages defined as "eligible mortgages" and the expansion of collateral for cover pools to include other assets, such as second-lien home equity loans and home equity lines of credit, credit card receivables, mortgages on commercial properties, public sector debt, and student loans. Other commenters requested that "eligible mortgages" should be defined solely by their loan-to-value (LTV) ratios. After considering these comments, the FDIC has determined that its interests in efficient resolution of IDIs, as well as in the initial development of a resilient covered bond market that can provide reliable liquidity for well-underwritten mortgages, support retention of the limitations on collateral for qualifying covered bonds in the Interim Policy Statement. Recent market experience demonstrates that many mortgages that would not qualify under the Policy Statement, such as low documentation mortgages, have declined sharply in value as credit conditions have deteriorated. Some of the other assets proposed are subject to substantial volatility as well, while others would not specifically support additional liquidity for well-underwritten residential mortgages. As noted above, certain provisions of the Policy Statement may be reviewed and reconsidered as the U.S. covered bond market develops.

With regard to the comments that LTV be used as a guide to determine an "eligible mortgage," the FDIC does not believe that LTV can substitute for strong underwriting criteria to ensure sustainable mortgages. In response to the comments, and the important role that LTV plays in mortgage analysis, the Policy Statement will urge issuers to disclose LTV for mortgages in the cover pool to enhance transparency for the covered bond market and promote stable cover pools. However, no specific LTV limitation will be imposed.

Two commenters suggested that the Policy Statement should be clarified to permit the substitution of cash as cover pool collateral. The Policy Statement has been modified to allow for the substitution of cash and Treasury and agency securities. The substitution of such collateral does not impair the strength of the cover pool and may be an important tool to limit short-term strains on issuing IDIs if eligible mortgages or AAA-rated mortgage securities must be withdrawn from the cover pool.

A number of commenters requested guidance on the calculation of damages the receiver will pay to holders of covered bonds in the case of repudiation or default. Under 12 U.S.C. 1821(e)(3), the liability of the conservator or receiver for the disaffirmance or repudiation of any contract is limited to "actual direct compensatory damages" and determined as of the date of appointment of the conservator or receiver. In the repudiation of contracts, such damages generally are defined by the amount due under the contract repudiated, but excluding any amounts for lost profits or opportunities, other indirect or contingent claims, pain and suffering, and exemplary or punitive damages. Under the Policy Statement, the FDIC agrees that "actual direct compensatory damages" due to bondholders, or their representative(s), for repudiation of covered bonds will be limited to the par value of the bonds plus accrued interest as of the date of appointment of the FDIC as conservator or receiver. The FDIC anticipates that IDIs issuing covered bonds, like other obligations bearing interest rate or other risks, will undertake prudent hedging strategies for such risks as part of their risk management program.

Many commenters suggested that the 10-year term limit should be removed to permit longer-term covered bond maturities. After reviewing the comments, the FDIC agrees that longer-term covered bonds should not pose a significant, additional risk and may avoid short-term funding volatility. Therefore, the FDIC has revised the Interim Policy Statement by increasing the term limit for covered bonds from 10 years to 30 years.

A number of the Federal Home Loan Banks, and their member institutions, objected to the inclusion of FHLB advances in the definition of "secured liabilities," any imposed cap on such advances, and any change in assessment rates. Under 12 CFR part 360.2 (Federal Home Loan Banks as Secured Creditors), secured liabilities include loans from the Federal Reserve Bank discount window, Federal Home Loan Bank (FHLB) advances, repurchase agreements, and public deposits. However, the Policy Statement does not impose a cap on FHLB advances and has no effect on an IDI's ability to obtain FHLB advances or its deposit insurance assessments. The Policy Statement solely addresses covered bonds.

However, as noted above, where an IDI relies very heavily on secured liabilities to finance its lending and other business activities, it does pose a greater risk of loss to the Deposit Insurance Fund in any failure. Should the covered bond market develop as a significant source of funding for IDIs, and should that development create

substantial increases in an IDI's reliance on secured funding, it would increase the FDIC's losses in a failure and perhaps outweigh the benefits of improved liquidity. As a result, it is appropriate for the FDIC to consider the risks of such increased losses. Consideration of these risks may occur in a possible future request for comments on secured liabilities, but they are not addressed in this Policy Statement.

III. Final Statement of Policy

For the purposes of this final Policy Statement, a "covered bond" is defined as a non-deposit, recourse debt obligation of an IDI with a term greater than one year and no more than thirty years, that is secured directly or indirectly by a pool of eligible mortgages or, not exceeding ten percent of the collateral, by AAA-rated mortgage bonds. The term "covered bond obligee" is the entity to which the IDI is indebted.

To provide guidance to potential covered bond issuers and investors, while allowing the FDIC to evaluate the potential benefits and risks that covered bond transactions may pose to the deposit insurance fund in the U.S. mortgage market, the application of the policy statement is limited to covered bonds that meet the following standards.

This Policy Statement only applies to covered bond issuances made with the consent of the IDI's primary federal regulator in which the IDI's total covered bond obligations at such issuance comprise no more than 4 percent of an IDI's total liabilities. The FDIC is concerned that unrestricted growth while the FDIC is evaluating the potential benefits and risks of covered bonds could excessively increase the proportion of secured liabilities to unsecured liabilities. The larger the balance of secured liabilities on the balance sheet, the smaller the value of assets that are available to satisfy depositors and general creditors, and consequently the greater the potential loss to the Deposit Insurance Fund. To address these concerns, the policy statement is limited to covered bonds that comprise no more than 4 percent of a financial institution's total liabilities after issuance.

In order to limit the risks to the deposit insurance fund, application of the Policy Statement is restricted to covered bond issuances secured by perfected security interests under applicable state and federal law on performing eligible mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income, a limited volume of AAA-rated mortgage securities, and certain substitution collateral. The Policy Statement provides that the mortgages shall be underwritten at the fully indexed rate relying on documented income, and comply with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination. In addition, the Policy Statement requires that the eligible mortgages and other collateral pledged for the covered bonds be held and owned by the IDI. This requirement is designed to protect the FDIC's interests in any over collateralization and avoid structures involving the transfer of the collateral to a subsidiary or SPV at initiation or prior to any IDI default under the covered bond transaction.

The FDIC recognizes that some covered bond programs include mortgage-backed securities in limited quantities. Staff believes that allowing some limited inclusion of AAA-rated mortgage-backed securities as collateral for covered bonds during this interim, evaluation period will support enhanced liquidity for mortgage finance without increasing the risks to the deposit insurance fund. Therefore, covered bonds that include up to 10 percent of their collateral in AAA-rated mortgage securities backed solely by mortgage loans that are made in compliance with guidance referenced above will meet the standards set forth in the Policy Statement. In addition, substitution collateral for the covered bonds may include cash and Treasury and agency securities as necessary to prudently manage the cover pool. Securities backed by tranches in other securities or assets (such as Collateralized Debt Obligations) are not considered to be acceptable collateral.

The Policy Statement provides that the consent of the FDIC, as conservator or receiver, is provided to covered bond obligees to exercise their contractual rights over collateral for covered bond transactions conforming to the Interim Policy Statement no sooner than ten (10) business days after a monetary default on an IDI's obligation to the covered bond obligee, as defined below, or ten (10) business days after the effective date of repudiation as provided in written notice by the conservator or receiver.

The FDIC anticipates that future developments in the marketplace may present interim final covered bond structures and structural elements that are not encompassed within this Policy Statement and therefore the FDIC may consider future amendment (with appropriate notice) of this Policy Statement as the U.S. covered bond market develops.

IV. Scope and Applicability

This Policy Statement applies to the FDIC in its capacity as conservator or receiver of an insured depository institution.

This Policy Statement only addresses the rights of the FDIC under 12 U.S.C. 1821(e)(13)(C). A previous policy statement entitled "Statement of Policy on Foreclosure Consent and Redemption Rights," August 17, 1992, separately addresses consent under 12 U.S.C. 1825(b), and should be separately consulted.

This Policy Statement does not authorize, and shall not be construed as authorizing, the waiver of the prohibitions in 12 U.S.C. 1825(b)(2) against levy, attachment, garnishment, foreclosure or sale of property of the FDIC, nor does it authorize or shall it be construed as authorizing the attachment of any involuntary lien upon the property of the FDIC. The Policy Statement provides that it shall not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC to take any action or to exercise any power not specifically mentioned, including but not limited to any rights, powers or remedies of the FDIC regarding transfers taken in contemplation of the institution's insolvency or with the intent to hinder, delay or defraud the institution or the creditors of such institution, or that is a fraudulent transfer under applicable law.

The Board of Directors of the FDIC has adopted a final Covered Bond Policy Statement. The text of the Covered Bond Policy Statement follows:

Covered Bond Policy Statement

Background

Insured depository institutions ("IDIs") are showing increasing interest in issuing covered bonds. Although covered bond structures vary, in all covered bonds the IDI issues a debt obligation secured by a pledge of assets, typically mortgages. The debt obligation is either a covered bond sold directly to investors, or mortgage bonds which are sold to a trust or similar entity ("special purpose vehicle" or "SPV") as collateral for the SPV to sell covered bonds to investors. In either case, the IDI's debt obligation is secured by a perfected first

priority security interest in pledged mortgages, which remain on the IDI's balance sheet. Proponents argue that covered bonds provide new and additional sources of liquidity and diversity to an institution's funding base. Based upon the information available to date, the FDIC agrees that covered bonds may be a useful liquidity tool for IDIs as part of an overall prudent liquidity management framework and the parameters set forth in this policy statement. Because of the increasing interest IDIs have in issuing covered bonds, the FDIC has determined to issue this policy statement with respect to covered bonds.

(a) Definitions.

(1) For the purposes of this policy statement, a "covered bond" shall be defined as a non-deposit, recourse debt obligation of an IDI with a term greater than one year and no more than thirty years, that is secured directly or indirectly by perfected security interests under applicable state and federal law on assets held and owned by the IDI consisting of eligible mortgages, or AAA-rated mortgage-backed securities secured by eligible mortgages if for no more than ten percent of the collateral for any covered bond issuance or series. Such covered bonds may permit substitution of cash and United States Treasury and agency securities for the initial collateral as necessary to prudently manage the cover pool.

(2) The term "eligible mortgages" shall mean performing first-lien mortgages on one-to-four family residential properties, underwritten at the fully indexed rate[6] and relying on documented income, and complying with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination. Due to the predictive quality of loan-to-value ratios in evaluating residential mortgages, issuers should disclose loan-to-value ratios for the cover pool to enhance transparency for the covered bond market.

[6] The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

(3) The term "covered bond obligation," shall be defined as the portion of the covered bond transaction that is the insured depository institution's debt obligation, whether to the SPV, mortgage bond trustee, or other parties.

(4) The term "covered bond obligee" is the entity to which the insured depository institution is indebted.

(5) The term "monetary default" shall mean the failure to pay when due (taking into account any period for cure of such failure or for forbearance provided under the instrument or in law) sums of money that are owed, without dispute, to the covered bond obligee under the terms of any *bona fide* instrument creating the obligation to pay.

(6) The term "total liabilities" shall mean, for banks that file quarterly Reports of Condition and Income (Call Reports), line 21 "Total liabilities" (Schedule RC); and for thrifts that file quarterly Thrift Financial Reports (TFRs), line SC70 "Total liabilities" (Schedule SC).

(b) Coverage. This policy statement only applies to covered bond issuances made with the consent of the IDI's primary federal regulator in which the IDI's total covered bond obligation as a result of such issuance comprises no more than 4 percent of an IDI's total liabilities, and only so long as the assets securing the covered bond obligation are eligible mortgages or AAA-rated mortgage securities on eligible mortgages, if not exceeding 10 percent of the collateral for any covered bond issuance. Substitution for the initial cover pool collateral may include cash and Treasury and agency securities as necessary to prudently manage the cover pool.

(c) Consent to certain actions. The FDIC as conservator or receiver consents to a covered bond obligee's exercise of the rights and powers listed in 12 U.S.C. 1821(e)(13)(C), and will not assert any rights to which it may be entitled pursuant to 12 U.S.C. 1821(e)(13)(C), after the expiration of the specified amount of time, and the occurrence of the following events

(1) If at any time after appointment the conservator or receiver is in a monetary default to a covered bond obligee, as defined above, and remains in monetary default for ten (10) business days after actual delivery of a written request to the FDIC pursuant to paragraph (d) hereof to exercise contractual rights because of such monetary default, the FDIC hereby consents pursuant to 12 U.S.C. 1821(e)(13)(C) to the covered bond obligee's exercise of any such contractual rights, including liquidation of properly pledged collateral by commercially reasonable and expeditious methods taking into account existing market conditions, provided no involvement of the receiver or conservator is required.

(2) If the FDIC as conservator or receiver of an insured depository institution provides a written notice of repudiation of a contract to a covered bond obligee, and the FDIC does not pay the damages due pursuant to 12 U.S.C. 1821(e) by reason of such repudiation within ten (10) business days after the effective date of the notice, the FDIC hereby consents pursuant to 12 U.S.C. 1821(e)(13)(C) for the covered bond obligee's exercise of any of its contractual rights, including liquidation of properly pledged collateral by commercially reasonable and expeditious methods taking into account existing market conditions, provided no involvement of the receiver or conservator is required.

(3) The liability of a conservator or receiver for the disaffirmance or repudiation of any covered bond issuance obligation, or for any monetary default on, any covered bond issuance, shall be limited to the par value of the bonds issued, plus contract interest accrued thereon to the date of appointment of the conservator or receiver.

(d) Consent. Any party requesting the FDIC's consent as conservator or receiver pursuant to 12 U.S.C. 1821(e)(13)(C) pursuant to this policy statement should provide to the Deputy Director, Division of Resolutions and Receiverships, Federal Deposit Insurance Corporation, 550 17th Street, N.. F–7076, ashington DC 2042 – 0002, a statement of the basis upon which such request is made, and copies of all documentation supporting such request, including without limitation a copy of the applicable contract and of any applicable notices under the contract.

(e) Limitations. The consents set forth in this policy statement do not act to waive or relinquish any rights granted to the FDIC in any capacity, pursuant to any other applicable law or any agreement or contract. Nothing contained in this policy alters the claims priority of collateral ed obligations. Nothing contained in this policy statement shall be construed as permitting the avoidance of any legally enforceable or perfected security interest in any of the assets of an insured depository institution, provided such interest is not taken in contemplation of the institution's insolvency, or with the intent to hinder,

delay or defraud the IDI or its creditors. Subject to the provisions of 12 U.S.C. 1821(e)(13)(C), nothing contained in this policy statement shall be construed as permitting the conservator or receiver to fail to comply with otherwise enforceable provisions of a contract or preventing a covered bond obligee's exercise of any of its contractual rights, including liquidation of properly pledged collateral by commercially reasonable methods.

(f) No waiver. This policy statement does not authorize, and shall not be construed as authorizing the waiver of the prohibitions in 12 U.S.C. 1825(b)(2) against levy, attachment, garnishment, foreclosure, or sale of property of the FDIC, nor does it authorize nor shall it be construed as authorizing the attachment of any involuntary lien upon the property of the FDIC. Nor shall this policy statement be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC to take any action or to exercise any power not specifically mentioned; including but not limited to any rights, powers or remedies of the FDIC regarding transfers taken in contemplation of the institution's insolvency or with the intent to hinder, delay or defraud the institution or the creditors of such institution, or that is a fraudulent transfer under applicable law.

(g) No assignment. The right to consent under 12 U.S.C. 1821(e)(13)(C) may not be assigned or transferred to any purchaser of property from the FDIC, other than to a conservator or bridge bank.

(h) Repeal. This policy statement may be repealed by the FDIC upon 30 days notice provided in the **Federal Register**, but any repeal shall not apply to any covered bond issuance made in accordance with this policy statement before such repeal.

By order of the Board of Directors.

Dated at Washington, DC this 22d day of July, 2008.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

[FR Doc. E8–17168 Filed 7–23–08; 8:45 am]

BILLING CODE 8714–01–P

FEDERAL MARITIME COMMISSION

Agency Information Collection Activities: Submission for OMB Review; Comment Request

AGENCY: Federal Maritime Commission.

ACTION: Notice.

SUMMARY: The Federal Maritime Commission (FMC or Commission) is giving public notice that the agency has submitted to OMB for approval the information collections described in this notice. The public is invited to comment on the proposed information collections pursuant to the Paperwork Reduction Act of 1995.

DATES: Written comments must be submitted to OMB at the address below on or before August 27, 2008 to be assured of consideration.

ADDRESSES: Send comments to the Office of Information and Regulatory Affairs, Office of Management and Budget, *Attention:* Desk Officer for FMC, 725 17th Street, NW., Washington, DC 20503, *OIRA_Submission@OMB.EOP.GOV* or fax (202) 395–5806.

FOR FURTHER INFORMATION CONTACT: Requests for additional information or copies of the proposed information collections and supporting statements should be directed to Jane Gregory at telephone number 202–523–5800 or *jgregory@fmc.gov*.

SUPPLEMENTARY INFORMATION: Pursuant to the Paperwork Reduction Act of 1995 (Pub. L. 104–13), the FMC invites the general public and other Federal agencies to comment on proposed information collections. On May 13, 2008, the FMC published a notice and request for comments in the **Federal Register** (73 FR 27537) regarding the agency's request for continued approval from OMB for information collections as required by the Paperwork Reduction Act of 1995. The FMC received no comments on any of the requests for extensions of OMB clearance. The FMC has submitted the described information collections to OMB for approval.

In response to this notice, comments and suggestions should address one or more of the following points: (1) The necessity and utility of the proposed information collection for the proper performance of the agency's functions; (2) the accuracy of the estimated burden; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) the use of automated collection techniques or other forms of information technology to minimize the information collection burden.

n ormation olle tions en or omment

it e: 46 CFR part 540—Application for Certificate of Financial Responsibility/Form FMC–131.

OMB A rova umber: 3072–0012 (Expires September 30, 2008).

Abstract: Sections 2 and 3 of Public Law 89–777 (46 U.S.C. 44105 and 44106) require owners or charterers of passenger vessels with 50 or more passenger berths or stateroom accommodations and embarking passengers at United Stated ports and territories to establish their financial responsibility to meet liability incurred for death or injury to passengers and other persons, and to indemnify passengers in the event of nonperformance of transportation. The Commission's Rules at 46 CFR part 540 implement Public Law 89–777 and specify financial responsibility coverage requirements for such owners and charterers.

urrent Actions: There are no changes to this information collection, and it is being submitted for extension purposes only.

y e of Revie : Extension.

ee s an ses: The information will be used by the Commission's staff to ensure that passenger vessel owners and charterers have evidenced financial responsibility to indemnify passengers and others in the event of nonperformance or casualty.

re uency: This information is collected when applicants apply for a certificate or when existing certificants change any information in their application forms.

y e of Res on ents: The types of respondents are owners, charterers and operators of passenger vessels with 50 or more passenger berths that embark passengers from U.S. ports or territories.

umber of Annua Res on ents: The Commission estimates an annual respondent universe of 50.

Estimate ime Per Res onse: The time per response ranges from .5 to 8 person hours for reporting and recordkeeping requirements contained in the rules, and 8 person hours for completing Application Form FMC–131.

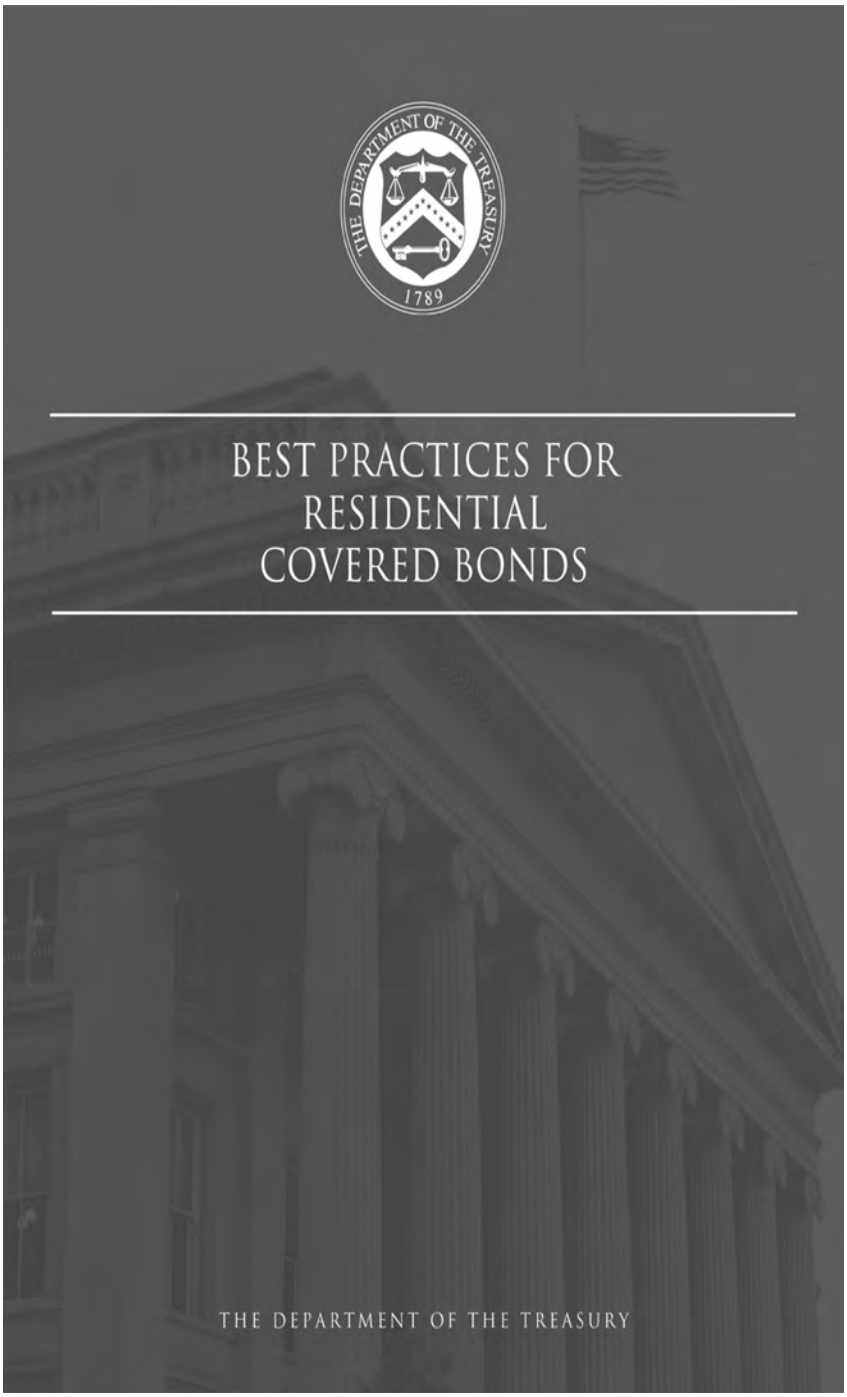
ota Annua Bur en: The Commission estimates the total person hour burden at 1,478 person hours.

it e: 46 CFR part 565—Controlled Carriers.

OMB A rova umber: 3072–0060 (Expires September 30, 2008).

Abstract: Section 9 of the Shipping Act of 1984 (46 U.S.C. 40701–40706) requires that the FMC monitor the practices of controlled carriers to ensure that they do not maintain rates or charges in their tariffs and service contracts that are below a level that is just and reasonable; nor establish, maintain or enforce unjust or unreasonable classifications, rules or regulations in those tariffs or service contracts which result or are likely to result in the carriage or handling of cargo at rates or charges that are below a just and reasonable level. 46 CFR part

APPENDIX B
TREASURY DEPARTMENT BEST PRACTICES GUIDE FOR COVERED BONDS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UNITED STATES DEPARTMENT OF THE TREASURY
BEST PRACTICES FOR RESIDENTIAL COVERED BONDS

July 2008

Henry M. Paulson, Jr.
Secretary of the Treasury

Table of Contents

I. Background

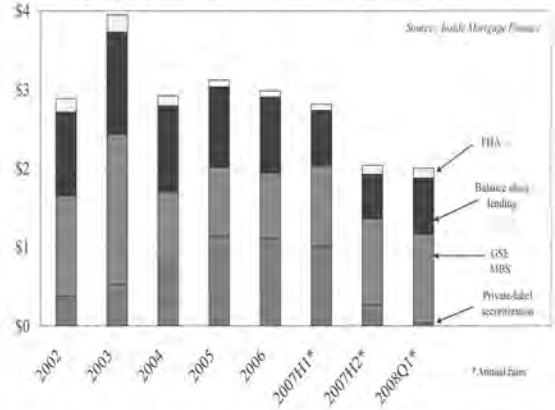
This Best Practices guide has been prepared by the Department of the Treasury ("Treasury") in order to encourage the growth of the Covered Bond market in the United States. Treasury believes that Covered Bonds represent a potential additional source of financing that could reduce borrowing costs for homeowners, improve liquidity in the residential mortgage market, and help depository institutions strengthen their balance sheets by diversifying their funding sources.

U.S. depository institutions have historically utilized several different funding sources to originate new residential mortgage loans, both for sale to investors and for their own portfolios. For loans sold into the market, depository institutions' funding options included selling the loans directly to investors, Fannie Mae, or Freddie Mac, and via private-label securitization. For loans retained on their balance sheets, depository institutions' funding options included utilizing their customers' deposits, issuing unsecured debt, and pledging their mortgages as collateral for advances from the Federal Home Loan Banks.

Recent market turmoil has severely limited the ability of depository institutions to sell loans to investors via private-label securitization. Consistent with their important public policy mission, the government-sponsored enterprises, Fannie Mae, Freddie Mac and the Federal Home Loans Banks, as well as the Federal Housing Administration have been playing a critical role by providing mortgage finance during this strained period. Even so, many depository institutions are keeping more mortgage loans on their balance sheets and are therefore seeking new sources of on-balance sheet financing. Many U.S. depository institutions are examining the potential of Covered Bonds to provide this financing while at the same time diversifying their overall funding portfolio.

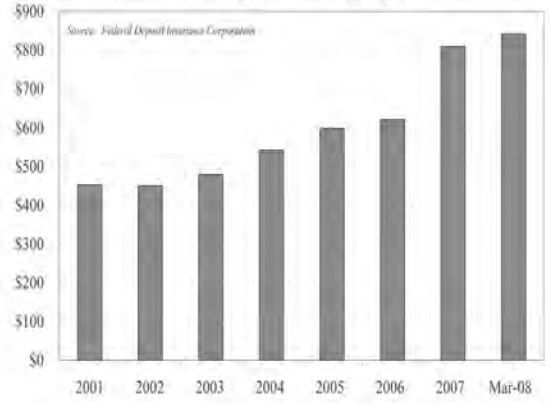
Private-label securitization has become strained. The GSEs, FHA and balance sheet lending have expanded in response. Nonetheless, total mortgage originations have fallen.

Mortgage Originations by Source of Funding (trillions of dollars)



The Federal Home Loan Banks are playing an important and expanded role funding lenders' balance sheets.

Federal Home Loan Bank Advances
(billions of dollars outstanding, end of period)



Even with the expanded roles of Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Housing Administration, mortgage spreads are increasing for all classes of mortgage loans.

Mortgage Rate Spreads to 10-Year Treasury (percent)

Covered Bonds present an alternative source of funding for institutions that can complement other sources of financing for a wide range of high-quality assets. In Europe, Covered Bonds are highly liquid instruments which are typically sold to rate-product investors rather than credit-product investors. While a Covered Bond market is already well-established in Europe, to date only two U.S. depository institutions have issued Covered Bonds. Given current challenges in other financing markets, U.S. institutions may find Covered Bonds to be an attractive source of funding for mortgage loans.

Treasury expects private-label securitization to return to the U.S. mortgage market, enabling homeowners to benefit from a broad, global investor base. Given the size of the U.S. residential mortgage market, Treasury believes there will be a role for all sources of mortgage funding in the future.

II. Objective

In preparing this report, Treasury seeks to bring increased clarity and homogeneity to the United States Covered Bond market by developing a series of Best Practices. Although the United States does not have dedicated Covered Bond legislation, Treasury believes these Best Practices may serve as a starting-point for the market, by encouraging issuers to use a common and simplified structure with high quality collateral for Covered Bond issuances. However, this document does not imply that Treasury favors Covered Bonds over other financing options available to depository institutions. Instead, Treasury views Covered Bonds as an additional, complementary funding source for the $11 trillion residential mortgage market.

Treasury has limited these Best Practices specifically to Covered Bonds backed by collateral consisting of high quality residential mortgage loans for two reasons. First, a liquid Covered Bond market based on residential mortgages may provide additional funding for the housing market, in turn lowering mortgage rates for homeowners. Second, focusing on one type of collateral while the market is nascent will provide simplicity for market participants. However, Treasury expects that the Covered Bond market to develop over time and the collateral securing Covered Bonds may eventually include other asset classes.

It should be noted that these Best Practices serve as a complement to the Federal Deposit Insurance Corporation's *Final Covered Bond Policy Statement* dated July 15, 2008 (see Appendix B). This statement specifies actions that the FDIC will take during an insolvency or receivership if the Covered Bond meets certain minimum requirements.

Finally, while these Best Practices have been developed to facilitate the growth of the Covered Bond market, they should not constrain the market in the future. Treasury fully expects the structure, collateral and other key terms of Covered Bonds to evolve with the growth of this market in the United States.

In preparing this Best Practices document, Treasury discussed the potential development of the U.S. Covered Bond market with both U.S. and European regulators, as well as numerous market participants, including potential issuers, investors, underwriters, rating agencies, law firms, financial counterparties, service providers and trade associations.

III. Covered Bond Definition

For the purposes of this document, a Covered Bond is defined as follows:

A Covered Bond is a debt instrument secured by a perfected security interest in a specific pool of collateral ("Cover Pool"). A Covered Bond provides funding to a depository institution ("issuer") that retains a Cover Pool of residential mortgage assets and related credit risk on its balance sheet. Interest on the Covered Bond is paid to investors from the issuer's general cash flows, while the Cover Pool serves as secured collateral. This Cover Pool consists of a portfolio of performing residential mortgage loans that meet specified underwriting criteria and are actively managed by the issuer to meet certain characteristics. If assets within the Cover Pool become non-performing, they must be replaced with performing assets. Finally, the issuer must maintain a Cover Pool in excess of the notional value of the Covered Bond ("overcollateralization") at all times. Multiple issuances for a depository institution may utilize a common Cover Pool.

In the event of an issuer default, Covered Bond investors first have recourse to the Cover Pool. In the event the Cover Pool returns less than par in liquidation, investors retain an unsecured claim on the issuer ranking pari passu with other unsecured creditors. Hence, Covered Bonds provide dual recourse to both the Cover Pool and the issuer, and the overcollateralization of the Cover Pool helps to mitigate the risk that investors would receive less than par in the event of an issuer default.

Comparison to Unsecured Debt

Unsecured debt differs significantly from Covered Bonds because of the absence of secured collateral underlying the obligation of the issuer. While unsecured debt investors retain an unsecured claim on the issuer in the event of issuer default, Covered Bond investors possess dual recourse to both the underlying collateral of a Covered Bond and to the individual issuer. Accordingly, Covered Bonds provide investors with additional protection on their investment compared with unsecured debt.

Comparison to Mortgage-Backed Securities

Although both mortgage-backed securities ("MBS") and Covered Bonds are a potential source of long-term funding for residential mortgage loans, there are several essential differences between Covered Bonds and MBS that make each attractive to different types of investors:

- Mortgages that secure a Covered Bond remain on the issuer's balance sheet, unlike MBS where mortgages are packaged and sold to investors.

- The cash flow from the mortgages and credit enhancements in MBS are generally the only source of principal and interest payments to the MBS investors. In a Covered Bond, principal and interest are paid by the issuer's cash flows, while the mortgages in the Cover Pool only serve as collateral for investors.
- The collateral underlying Covered Bonds is dynamic and non-performing (or prepaying) assets within the Cover Pool must be substituted with performing mortgages. Mortgages underlying MBS are static and remain in each MBS until maturity.
- In the case of an issuer default, Covered Bonds are structured to avoid prepayment prior to the date of maturity. This is accomplished through swap agreements and deposit agreements (e.g., guaranteed investment contracts). MBS investors, in contrast, are exposed to prepayment risk in the case of a mortgage default or prepayment.
- In the event that the Covered Bonds do accelerate and repay investors at an amount less than the principal and accrued interest, investors retain an unsecured claim on the issuer. MBS investors generally do not retain any claim on the issuer in the event of repayment at an amount less than the principal and interest owed.

IV. History of the Covered Bond Market

The Covered Bond market has a long and extensive history in Europe, dating back more than 230 years to the initial Prussian issuance in 1770. Covered Bonds were initially used to finance agriculture and later became focused on residential and commercial real estate markets. While Covered Bonds remained popular throughout the 19th century, during the 20th century they were somewhat eclipsed given other advances in the inter-bank financing markets. However, in 1995 the first German jumbo Covered Bond was issued, meeting investor demand for increasingly liquid products.[1] Since that time, the Covered Bond market has accelerated in Europe, partly due to the fact that Europe does not have government-sponsored enterprises such as Fannie Mae, Freddie Mac or the Federal Home Loan Banks. Furthermore, the collateral behind European Covered Bonds includes residential and commercial mortgages as well as public sector debt. At the end of 2007, the Covered Bond market stood at over EUR 2.11 trillion.[2] To date, two U.S. institutions have issued Covered Bonds.

Nearly all European countries have adopted Covered Bonds into their financial system. Depending on the jurisdiction, Covered Bonds may be governed by legislation (i.e. a "legislative framework") or by contract (i.e. a "structured framework"). Typically, a legislative framework exists in nations with a long history of Covered Bonds while nations with a relatively young Covered Bond market, such as Canada and Japan have a structured framework. In countries with a legislative framework there is often a dedicated regulator that governs the issuance and repayment of Covered Bonds. Moreover, a legislative framework helps to standardize Covered Bonds, providing homogeneity and simplicity to the market. This Best Practices document seeks to offer such structure to the U.S. market.

V. Important Considerations

The purpose of this document is to present a standardized model for Covered Bonds issued in the United States in the absence of dedicated legislation. Investors should recognize that like all investments, Covered Bonds carry risk. Investors should perform their own due diligence and review risk factors and associated disclosure before investing in any Covered Bond. These Best Practices only serve as a template for market participants and do not in any way provide or imply a government guarantee of any kind. It should also be understood that these Best Practices do not attempt to address requirements arising from federal securities laws or any other legal framework.

VI. Best Practices Template

For a Covered Bond program to be consistent with this Best Practices Template, the program's documentation must conform to the following provisions throughout the life of the program, not only at the time of issuance. *Italics indicate provisions that are specified in the final FDIC policy statement*[3].

Issuer

The issuer may be:

- *A newly created, bankruptcy-remote SPV ("SPV Structure")*[4]
- *A depository institution and/or a wholly-owned subsidiary of a depository institution ("Direct Issuance Structure")*

Security

Under the current SPV Structure, the issuer's primary assets must be a mortgage bond purchased from a depository institution. The mortgage bond must be secured at the depository institution by a dynamic pool of residential mortgages.

Under the Direct Issuance Structure, the issuing institution must designate a Cover Pool of residential mortgages as the collateral for the Covered Bond, which remains on the balance sheet of the depository institution.

In both structures, the Cover Pool must be owned by the depository institution. Issuers of Covered Bonds must provide a first priority claim on the assets in the Cover Pool to bond holders, and the assets in the Cover Pool must not be encumbered by any other lien. The issuer must clearly identify the Cover Pool's assets, liabilities, and security pledge on its books and records.

Maturity

The maturity for Covered Bonds shall be greater than one year and no more than thirty years. While the majority of early issuances will likely have maturities between one and ten years, we expect longer dated issuances may develop over time.

Eligible Cover Pool Collateral

The collateral in the Cover Pool must meet the following requirements at all times:

- *Performing mortgages on one-to-four family residential properties*
- *Mortgages shall be underwritten at the fully-indexed rate*[3]
- *Mortgages shall be underwritten with documented income*
- *Mortgages must comply with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination*
- *Substitution collateral may include cash and Treasury and agency securities as necessary to prudently manage the Cover Pool*
- Mortgages must be current when they are added to the pool and any mortgages that become more than 60-days past due must be replaced
- Mortgages must be first lien only
- Mortgages must have a maximum loan-to-value ("LTV") of 80% at the time of inclusion in the Cover Pool
- A single Metro Statistical Area cannot make up more than 20% of the Cover Pool
- Negative amortization mortgages are not eligible for the Cover Pool
- Bondholders must have a perfected security interest in these mortgage loans.

Over-collateralization

Issuers must maintain an overcollateralization value at all times of at least 5% of the outstanding principal balance of the Covered Bonds (see "Asset Coverage Test").

For the purposes of calculating the minimum required overcollateralization in the Covered Bond, only the 80% portion of the updated LTV will be credited. If a mortgage in the Cover Pool has a LTV of 80% or less, the full outstanding principal value of the mortgage will be credited. If a mortgage has a LTV over 80%, only the 80% LTV portion of each loan will be credited (see Appendix A for examples).

	Issuers must update the LTV of mortgages in the Cover Pool on a quarterly basis using a nationally-recognized, regional housing price index or other comparable measurement.
Currency	Covered Bonds may be issued in any currency.
Interest Type	Covered Bonds may either be fixed or floating instruments.
Interest Payment Swaps	Issuers may enter into one or more swap agreements or similar contractual arrangements at the time of issuance. The purpose of such agreements include: • To provide scheduled interest payments on a temporary basis in the event the issuer becomes insolvent • To mitigate any timing mismatch, to the extent applicable, between interest payments and interest income These swap agreements must be with financially sound counterparties and the identity of the counterparties must be disclosed to investors.
Currency Swap	If a Covered Bond is issued in a different currency than the underlying Cover Pool (or Mortgage Bond, if applicable), the issuer shall employ a currency swap.
Specified Investment Contract	Issuers must enter into a deposit agreement, e.g., guaranteed investment contract, or other arrangement whereby the proceeds of Cover Pool assets are invested (any such arrangement, a "Specified Investment") at the time of issuance with or by one or more financially sound counterparties. Following a payment default by the issuer or repudiation by the FDIC as conservator or receiver, the Specified Investment should pay ongoing scheduled interest and principal payments so long as the Specified Investment provider receives proceeds of the Cover Pool assets at least equal to the par value of the Covered Bonds. The purpose of the Specified Investment is to prevent an acceleration of the Covered Bond due to the insolvency of the issuer.

Cover Pool Disclosure	Issuers must make available descriptive information on the Cover Pool with investors at the time an investment decision is being made and on a monthly basis after issuance. The SEC's Regulation AB provides a helpful template for preparing pool level information, such as presenting summary information in tabular or graphical format and using appropriate groups or ranges. Issuers must make this information available to investors no later than 30 days after the end of each month. As the Covered Bond market develops, issuers should consider disclosing metrics on the Cover Pools from their prior Covered Bonds whenever a new issuance occurs.
Substitution	If more than 10% of the Cover Pool is substituted within any month or if 20% of the Cover Pool is substituted within any one quarter, the issuer must provide updated Cover Pool information to investors.
Issuer Disclosure	The depository institution and the SPV (if applicable) must disclose information regarding its financial profile and other relevant information that an investor would find material.
Asset Coverage Test	The issuer must perform an Asset Coverage Test on a monthly basis to ensure collateral quality and the proper level of overcollateralization and to make any substitutions that are necessary to meet the provisions of this template. The results of this Asset Coverage Test and the results of any reviews by the Asset Monitor must be made available to investors.
Asset Monitor	The issuer must designate an independent Asset Monitor to periodically determine compliance with the Asset Coverage Test of the issuer.
Trustee	The issuer must designate an independent Trustee for the Covered Bonds. Among other responsibilities, this Trustee must represent the interest of investors and must enforce the investors' rights in the collateral in the event of an issuer's insolvency.

Treatment of Covered Bond Proceeds	In the event of a default, any losses must be allocated pro rata across Covered Bond issuances that utilize a common Cover Pool, irrespective of the maturity of the individual issuances.
SEC Registration	Covered Bonds may be issued as registered securities or may be exempt from registration under securities laws. This template is not meant to address disclosure and other requirements for a security registered with the Securities and Exchange Commission.
Regulatory Authorization	*Issuers must receive consent to issue Covered Bonds from their primary federal regulator.* Upon an issuer's request, their primary federal regulator will make a determination based on that agencies policies and procedures whether to give consent to the issuer to establish a Covered Bond program. Only well-capitalized institutions should issue Covered Bonds. As part of their ongoing supervisory efforts, primary federal regulators monitor an issuer's controls and risk management processes.
Issuance Limitations	*Covered Bonds may account for no more than four percent of an issuers' liabilities after issuance.*
Event of Breach of the Asset Coverage Test	If the Asset Coverage Test of the Covered Bond program is breached, the issuer has one month to correct such breach. If, after one month, the breach remains, the Trustee may terminate the Covered Bond program and principal and accrued interest will be returned to investors. While such a breach exists, the issuer may not issue any additional Covered Bonds.

Insolvency Procedures

As conservator or receiver for an insured depository institution (IDI), the FDIC has three options in responding to a properly structured Covered Bond transaction of the IDI:

1) continue to perform on the Covered Bond transaction under its terms;
2) pay-off the Covered Bonds in cash up to the value of the pledged collateral; or
3) allow liquidation of the pledged collateral to pay-off the Covered Bonds.

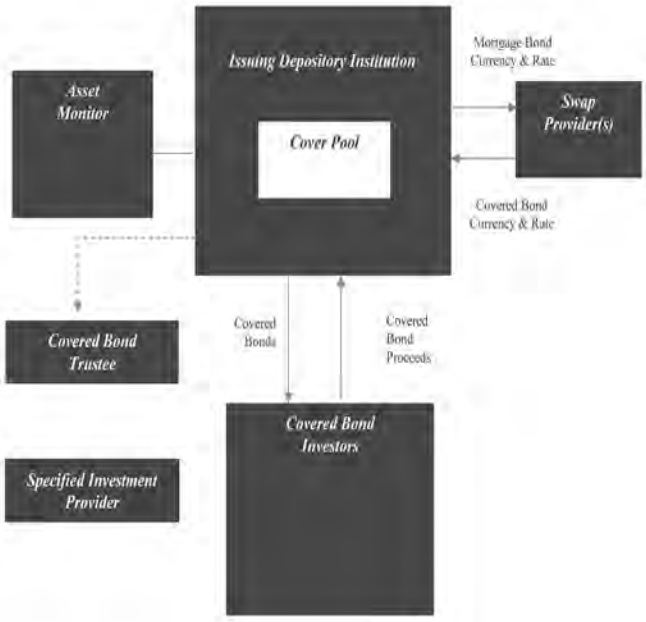
If the FDIC adopts the first option, it would continue to make the Covered Bond payments as scheduled. The second or third options would be triggered if the FDIC repudiated the transaction or if a monetary default occurred. In both cases, the par value of the Covered Bonds plus interest accrued to the date of the appointment of the FDIC as conservator or receiver would be paid in full up to the value of the collateral.

If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC, as conservator or receiver, for distribution as mandated by the Federal Deposit Insurance Act.

If there were insufficient collateral pledged to cover all valid claims by the secured parties, the amount of the claims in excess of the pledged collateral would be unsecured claims in the receivership.

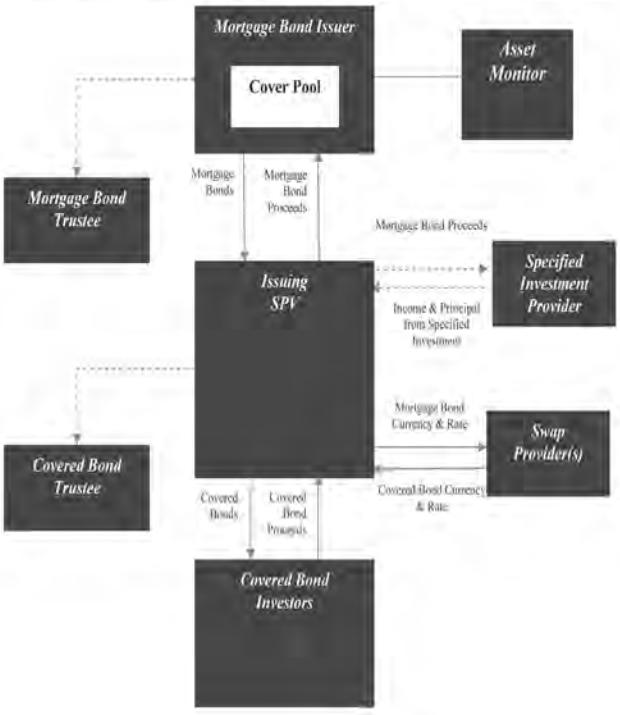
VII. Illustrative Direct Issuance

This diagram is meant to show what a potential structure could look like if the issuer of a Covered Bond were a depository institution. It is not intended to endorse a specific structure but rather serves an illustrative purpose. Issuers may develop other structures that are consistent with the template.



VIII. Illustrative SPV Issuance

This diagram is meant to show what a potential structure could look like if the issuer of a Covered Bond were a SPV. It is not intended to endorse a specific structure but rather serves an illustrative purpose. Issuers may develop other structures that are consistent with the template.



Endnotes

[1] European Covered Bond Council, December 2007.

[2] Ibid

[3] The FDIC's Final Covered Bond Policy Statement dated July 15, 2008 outlines specific actions that the FDIC will take during an insolvency or receivership if certain conditions are met. Italicized terms indicate provisions that are part of both the FDIC's statement and this Best Practices Template. However, these italicized terms are not meant to cover all of the provisions of the FDIC statement. Market participants should independently review the FDIC's statement to ensure conformity with all provisions.

[4] In addition to SPV programs with a single issuer, multiple depository institutions could potentially utilize a joint SPV to pool assets. Each issuer would be responsible for meeting appropriate requirements and receiving consent from its primary federal regulator.

[5] The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

Appendix A: Cover Pool Collateralization Calculation

As stated in Section VI., a minimum overcollateralization of 5% of the principal value of the Covered Bond must be maintained. Furthermore, mortgages must have a maximum LTV of 80% at the time of inclusion in the Cover Pool.

For the purposes of calculating the overcollateralization, 80% of the updated LTV will be credited towards the Cover Pool. For mortgages with an LTV of 80% or less, the full outstanding principal value will be credited. For mortgages with an LTV over 80%, only the 80% LTV portion of each loan will be credited.

This appendix provides examples of how loans may be credited against the required collateral of the Cover Pool.

ILLUSTRATIVE ASSUMPTIONS:

- $1,000 Covered Bond issuance
- Minimum overcollateralization of 5%
- Updated maximum LTV of 80% credited toward overcollateralization
- $1,050 of required collateral ($1,000 x 1.05)

Scenario A:

- Pool of $80 loans on homes with an updated value of $100
- $1,050 / ($80 x 1.0) = 13.125 loans required in Cover Pool

Scenario B:

- Pool of $60 loans on homes with an updated value of $100
- $1,050 / ($60 x 1.0) = 17.500 loans required in Cover Pool

Scenario C:

- Pool of $80 loans on homes with an updated value of $80
- $1,050 / ($80 x 0.8) = 16.406 loans required in Cover Pool

Appendix B: Final FDIC Covered Bond Policy Statement

FEDERAL DEPOSIT INSURANCE CORPORATION

Covered Bond Policy Statement

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Final Statement of Policy

SUMMARY: The Federal Deposit Insurance Corporation (the FDIC) is publishing a final policy statement on the treatment of covered bonds in a conservatorship or receivership. This policy statement provides guidance on the availability of expedited access to collateral pledged for certain covered bonds after the FDIC decides whether to terminate or continue the transaction. Specifically, the policy statement clarifies how the FDIC will apply the consent requirements of section 11(e)(13)(C) of the Federal Deposit Insurance Act (FDIA) to such covered bonds to facilitate the prudent development of the U.S. covered bond market consistent with the FDIC's responsibilities as conservator or receiver for insured depository institutions (IDI). As the U.S. covered bond market develops, future modifications or amendments may be considered by the FDIC.

FOR FURTHER INFORMATION CONTACT: Richard T. Aboussie, Associate General Counsel, Legal Division (703) 562-2452; Michael H. Krimminger, Special Advisor for Policy (202) 898-8950.

SUPPLEMENTARY INFORMATION

I. Background

On April 23, 2008, the FDIC published the Interim Final Covered Bond Policy Statement for public comment. 73 FR 21949 (April 23, 2008). After carefully reviewing and considering all comments, the FDIC has adopted certain limited revisions and clarifications to the Interim Policy Statement (as discussed in Part II) in the Final Policy Statement.[1]

Currently, there are no statutory or regulatory prohibitions on the issuance of covered bonds by U.S. banks. Therefore, to reduce market uncertainty and clarify the application of the FDIC's statutory authorities for U.S. covered bond transactions, the FDIC issued an Interim Policy Statement to provide guidance on the availability of expedited access to collateral pledged for certain covered bonds by IDIs in a conservatorship or a receivership. As discussed below, under section 11(e)(13)(C) of the FDIA, any liquidation of collateral of an IDI placed into

conservatorship or receivership requires the consent of the FDIC during the initial 45 days or 90 days after its appointment, respectively. Consequently, issuers of covered bonds have incurred additional costs from maintaining additional liquidity needed to insure continued payment on outstanding bonds if the FDIC as conservator or receiver fails to make payment or provide access to the pledged collateral during these periods after any decision by the FDIC to terminate the covered bond transaction. The Policy Statement does not impose any new obligations on the FDIC, as conservator or receiver, but does define the circumstances and the specific covered bond transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral.

Covered bonds are general, non-deposit obligation bonds of the issuing bank secured by a pledge of loans that remain on the bank's balance sheet. Covered bonds originated in Europe, where they are subject to extensive statutory and supervisory regulation designed to protect the interests of covered bond investors from the risks of insolvency of the issuing bank. By contrast, covered bonds are a relatively new innovation in the U.S. with only two issuers to date: Bank of America, N.A. and Washington Mutual. These initial U.S. covered bonds were issued in September 2006.

In the covered bond transactions initiated in the U.S. to date, an IDI sells mortgage bonds, secured by mortgages, to a trust or similar entity ("special purpose vehicle" or "SPV").[7] The pledged mortgages remain on the IDI's balance sheet, securing the IDI's obligation to make payments on the debt, and the SPV sells covered bonds, secured by the mortgage bonds, to investors. In the event of a default by the IDI, the mortgage bond trustee takes possession of the pledged mortgages and continues to make payments to the SPV to service the covered bonds. Proponents argue that covered bonds provide new and additional sources of liquidity and diversity to an institution's funding base.

The FDIC agrees that covered bonds may be a useful liquidity tool for IDIs as part of an overall prudent liquidity management framework and within the parameters set forth in the Policy Statement. While covered bonds, like other secured liabilities, could increase the costs to the deposit insurance fund in a receivership, these potential costs must be balanced with diversification of sources of liquidity and the benefits that accrue from additional on-balance sheet alternatives to securitization for financing mortgage lending. The Policy Statement seeks to balance these considerations by clarifying the conditions and circumstances under which the FDIC will grant automatic consent to access pledged covered bond collateral. The FDIC believes that the prudential limitations set forth in the Policy Statement permit the incremental development of the covered bond market, while allowing the FDIC, and other regulators, the opportunity to evaluate these transactions within the U.S. mortgage market. In fulfillment of its responsibilities as deposit insurer and receiver for failed IDIs, the FDIC will continue to review the development of the covered bond marketplace

in the U.S. and abroad to gain further insight into the appropriate role of covered bonds in IDI funding and the U.S. mortgage market, and their potential consequences for the deposit insurance fund. (For ease of reference, throughout this discussion, when we refer to "covered bond obligation," we are referring to the part of the covered bond transaction comprising the IDI's debt obligation, whether to the SPV, mortgage bond trustee, or other parties; and "covered bond obligee" is the entity to which the IDI is indebted.)

Under the FDIA, when the FDIC is appointed conservator or receiver of an IDI, contracting parties cannot terminate agreements with the IDI because of the insolvency itself or the appointment of the conservator or receiver. In addition, contracting parties must obtain the FDIC's consent during the forty-five day period after appointment of FDIC as conservator, or during the ninety day period after appointment of FDIC as receiver before, among other things, terminating any contract or liquidating any collateral pledged for a secured transaction.[3] During this period, the FDIC must still comply with otherwise enforceable provisions of the contract. The FDIC also may terminate or repudiate any contract of the IDI within a reasonable time after the FDIC's appointment as conservator or receiver if the conservator or receiver determines that the agreement is burdensome and that the repudiation will promote the orderly administration of the IDI's affairs.[4]

As conservator or receiver for an IDI, the FDIC has three options in responding to a properly structured covered bond transaction of the IDI: 1) continue to perform on the covered bond transaction under its terms; 2) pay-off the covered bonds in cash up to the value of the pledged collateral; or 3) allow liquidation of the pledged collateral to pay-off the covered bonds. If the FDIC adopts the first option, it would continue to make the covered bond payments as scheduled. The second or third options would be triggered if the FDIC repudiated the transaction or if a monetary default occurred. In both cases, the par value of the covered bonds plus interest accrued to the date of the appointment of the FDIC as conservator or receiver would be paid in full up to the value of the collateral. If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC, as conservator or receiver, for distribution as mandated by the FDIA. On the other hand, if there were insufficient collateral pledged to cover all valid claims by the secured parties, the amount of the claims in excess of the pledged collateral would be unsecured claims in the receivership.

While the FDIC can repudiate the underlying contract, and thereby terminate any continuing obligations under that contract, the FDIA prohibits the FDIC, as conservator or receiver from avoiding any legally enforceable or perfected security interest in the assets of the IDI unless the interest was taken in

contemplation of the IDI's insolvency or with the intent to hinder, delay, or defraud the IDI or its creditors.[5] This statutory provision ensures protection for

the valid claims of secured creditors up to the value of the pledged collateral. After a default or repudiation, the FDIC as conservator or receiver may either pay resulting damages in cash up to the value of the collateral or turn over the collateral to the secured party for liquidation. For example, if the conservator or receiver repudiated a covered bond transaction, as discussed in Part II below, it would pay damages limited to par value of the covered bonds and accrued interest up to the date of appointment of the conservator or receiver, if sufficient collateral was in the cover pool, or turn over the collateral for liquidation with the conservator or receiver recovering any proceeds in excess of those damages. In liquidating any collateral for a covered bond transaction, it would be essential that the secured party liquidate the collateral in a commercially reasonable and expeditious manner taking into account the then-existing market conditions.

As noted above, existing covered bond transactions by U.S. issuers have used SPVs. However, nothing in the Policy Statement requires the use of an SPV. Some questions have been posed about the treatment of a subsidiary or SPV after appointment of the FDIC as conservator or receiver. The FDIC applies well-defined standards to determine whether to treat such entities as "separate" from the IDI. If a subsidiary or SPV, in fact, has fulfilled all requirements for treatment as a "separate" entity under applicable law, the FDIC as conservator or receiver has not applied its statutory powers to the subsidiary's or SPV's contracts with third parties. While the determination of whether a subsidiary or SPV has been organized and maintained as a separate entity from the IDI must be determined based on the specific facts and circumstances, the standards for such decisions are set forth in generally applicable judicial decisions and in the FDIC's regulation governing subsidiaries of insured state banks, 12 C.F.R. § 362.4.

The requests to the FDIC for guidance have focused principally on the conditions under which the FDIC would grant consent to obtain collateral for a covered bond transaction before the expiration of the forty-five day period after appointment of a conservator or the ninety day period after appointment of a receiver. IDIs interested in issuing covered bonds have expressed concern that the requirement to seek the FDIC's consent before exercising on the collateral after a breach could interrupt payments to the covered bond obligee for as long as 90 days. IDIs can provide for additional liquidity or other hedges to accommodate this potential risk to the continuity of covered bond payments but at an additional cost to the transaction. Interested parties requested that the FDIC provide clarification about how FDIC would apply the consent requirement with respect to covered bonds. Accordingly, the FDIC has determined to issue this Final Covered Bond Policy Statement in order to provide covered bond issuers with final guidance on how the FDIC will treat covered bonds in a conservatorship or receivership.

II. Overview of the Comments

The FDIC received approximately 130 comment letters on the Interim Policy Statement; these included comments from national banks, Federal Home Loan Banks, industry groups and individuals.

Most commenters encouraged the FDIC to adopt the Policy Statement to clarify how the FDIC would treat covered bonds in the case of a conservatorship or receivership and, thereby, facilitate the development of the U.S. covered bond market. The more detailed comments focused on one or more of the following categories of issues: (1) the FDIC's discretion regarding covered bonds that do not comply with the Policy Statement; (2) application to covered bonds completed prior to the Policy Statement; (3) the limitation of the Policy Statement to covered bonds not exceeding 4 percent of liabilities; (4) the eligible collateral for the cover pools; (5) the measure of damages provided in the event of default or repudiation; (6) the covered bond term limit; and (7) federal home loan bank advances and assessments.

Certain banks and industry associations sought clarification about the treatment of covered bonds that do not comply with the Policy Statement by the FDIC as conservator or receiver. Specifically, commenters asked the FDIC to clarify that if a covered bond issuance is not in conformance with the Policy Statement, the FDIC retains discretion to grant consent prior to expiration of the 45 or 90 day period on a case-by-case basis. Under Section 11(e)(13)(C) of the FDIA, the exercise of any right or power to terminate, accelerate, declare a default, or otherwise affect any contract of the IDI, or to take possession of any property of the IDI, requires the consent of the conservator or receiver, as appropriate, during the 45-day period or 90-day period after the date of the appointment of the conservator or receiver, as applicable. By the statutory terms, the conservator or receiver retains the discretion to give consent on a case-by-case basis after evaluation by the FDIC upon the failure of the issuer.

Comments from banks who issued covered bonds prior to the Policy Statement requested either 'grandfathering' of preexisting covered bonds or an advance determination by the FDIC before any appointment of a conservator or receiver that specific preexisting covered bonds qualified under the Policy Statement. After carefully considering the comments, the FDIC has determined that to 'grandfather' or otherwise permit mortgages or other collateral that does not meet the specific requirements of the Policy Statement to support covered bonds would not promote stable and resilient covered bonds as encompassed within the Policy Statement. If preexisting covered bonds, and their collateral, otherwise qualify under the standards specified in the Policy Statement, those covered bonds would be eligible for the expedited access to collateral provided by the Policy Statement.

A number of commenters requested that the limitation of eligible covered bonds to no more than 4 percent of an IDI's total liabilities should be removed or increased. Commenters also noted that other countries applying a cap have based the limitation on assets, not liabilities. The Policy Statement applies to covered bond issuances that comprise no more than 4 percent of an institution's total liabilities since, in part, as the proportion of secured liabilities increases the unpledged assets available to satisfy the claims of the Deposit Insurance Fund, uninsured depositors and other creditors decreases. As a result, the FDIC must focus on the share of an IDI's liabilities that are secured by collateral and balance the additional potential losses in the failure of an IDI against the benefits of increased liquidity for open institutions. The 4 percent limitation under the Policy Statement is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market within the financial system of the United States, which differs in many respects from that in other countries deploying covered bonds. Consequently, while changes may be considered to this limitation as the covered bond market develops, the FDIC has decided not to make any change at this time.

A number of commenters sought expansion of the mortgages defined as "eligible mortgages" and the expansion of collateral for cover pools to include other assets, such as second-lien home equity loans and home equity lines of credit, credit card receivables, mortgages on commercial properties, public sector debt, and student loans. Other commenters requested that "eligible mortgages" should be defined solely by their loan-to-value (LTV) ratios. After considering these comments, the FDIC has determined that its interests in efficient resolution of IDIs, as well as in the initial development of a resilient covered bond market that can provide reliable liquidity for well-underwritten mortgages, support retention of the limitations on collateral for qualifying covered bonds in the Interim Policy Statement. Recent market experience demonstrates that many mortgages that would not qualify under the Policy Statement, such as low documentation mortgages, have declined sharply in value as credit conditions have deteriorated. Some of the other assets proposed are subject to substantial volatility as well, while others would not specifically support additional liquidity for well-underwritten residential mortgages. As noted above, certain provisions of the Policy Statement may be reviewed and reconsidered as the U.S. covered bond market develops.

With regard to the comments that LTV be used as a guide to determine an "eligible mortgage," the FDIC does not believe that LTV can substitute for strong underwriting criteria to ensure sustainable mortgages. In response to the comments, and the important role that LTV plays in mortgage analysis, the Policy Statement will urge issuers to disclose LTV for mortgages in the cover pool to enhance transparency for the covered bond market and promote stable cover pools. However, no specific LTV limitation will be imposed.

Two commenters suggested that the Policy Statement should be clarified to permit the substitution of cash as cover pool collateral. The Policy Statement has been modified to allow for the substitution of cash and Treasury and agency securities. The substitution of such collateral does not impair the strength of the cover pool and may be an important tool to limit short-term strains on issuing IDIs if eligible mortgages or AAA-rated mortgage securities must be withdrawn from the cover pool.

A number of commenters requested guidance on the calculation of damages the receiver will pay to holders of covered bonds in the case of repudiation or default. Under 12 USC § 1821(e)(3), the liability of the conservator or receiver for the disaffirmance or repudiation of any contract is limited to "actual direct compensatory damages" and determined as of the date of appointment of the conservator or receiver. In the repudiation of contracts, such damages generally are defined by the amount due under the contract repudiated, but excluding any amounts for lost profits or opportunities, other indirect or contingent claims, pain and suffering, and exemplary or punitive damages. Under the Policy Statement, the FDIC agrees that "actual direct compensatory damages" due to bondholders, or their representative(s), for repudiation of covered bonds will be limited to the par value of the bonds plus accrued interest as of the date of appointment of the FDIC as conservator or receiver. The FDIC anticipates that IDIs issuing covered bonds, like other obligations bearing interest rate or other risks, will undertake prudent hedging strategies for such risks as part of their risk management program.

Many commenters suggested that the 10-year term limit should be removed to permit longer-term covered bond maturities. After reviewing the comments, the FDIC agrees that longer-term covered bonds should not pose a significant, additional risk and may avoid short-term funding volatility. Therefore, the FDIC has revised the Interim Policy Statement by increasing the term limit for covered bonds from 10 years to 30 years.

A number of the Federal Home Loan Banks, and their member institutions, objected to the inclusion of FHLB advances in the definition of "secured liabilities," any imposed cap on such advances, and any change in assessment rates. Under 12 C.F.R. Part 360.2 (Federal Home Loan Banks as Secured Creditors), secured liabilities include loans from the Federal Reserve Bank discount window, Federal Home Loan Bank (FHLB) advances, repurchase agreements, and public deposits. However, the Policy Statement does not impose a cap on FHLB advances and has no effect on an IDI's ability to obtain FHLB advances or its deposit insurance assessments. The Policy Statement solely addresses covered bonds.

However, as noted above, where an IDI relies very heavily on secured liabilities to finance its lending and other business activities, it does pose a greater risk of loss to the Deposit Insurance Fund in any failure. Should the covered bond market develop as a significant source of funding for IDIs, and should that development create substantial increases in an IDI's reliance on secured funding, it would increase the FDIC's losses in a failure and perhaps outweigh the benefits of improved liquidity. As a result, it is appropriate for the FDIC to consider the risks of such increased losses. Consideration of these risks may occur in a possible future request for comments on secured liabilities, but they are not addressed in this Policy Statement.

III. Final Statement of Policy

For the purposes of this final Policy Statement , a "covered bond" is defined as a non-deposit, recourse debt obligation of an IDI with a term greater than one year and no more than thirty years, that is secured directly or indirectly by a pool of eligible mortgages or, not exceeding ten percent of the collateral, by AAA-rated mortgage bonds. The term "covered bond obligee" is the entity to which the IDI is indebted.

To provide guidance to potential covered bond issuers and investors, while allowing the FDIC to evaluate the potential benefits and risks that covered bond transactions may pose to the deposit insurance fund in the U.S. mortgage market, the application of the policy statement is limited to covered bonds that meet the following standards.

This Policy Statement only applies to covered bond issuances made with the consent of the IDI's primary federal regulator in which the IDI's total covered bond obligations at such issuance comprise no more than 4 percent of an IDI's total liabilities. The FDIC is concerned that unrestricted growth while the FDIC is evaluating the potential benefits and risks of covered bonds could excessively increase the proportion of secured liabilities to unsecured liabilities. The larger the balance of secured liabilities on the balance sheet, the smaller the value of assets that are available to satisfy depositors and general creditors, and consequently the greater the potential loss to the Deposit Insurance Fund. To address these concerns, the policy statement is limited to covered bonds that comprise no more than 4 percent of a financial institution's total liabilities after issuance.

In order to limit the risks to the deposit insurance fund, application of the Policy Statement is restricted to covered bond issuances secured by perfected security interests under applicable state and federal law on performing eligible mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income, a limited volume of AAA-rated mortgage securities, and certain substitution collateral. The Policy Statement provides that the mortgages shall be underwritten at the fully indexed rate relying on

documented income, and comply with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency

Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination. In addition, the Policy Statement requires that the eligible mortgages and other collateral pledged for the covered bonds be held and owned by the IDI. This requirement is designed to protect the FDIC's interests in any over collateralization and avoid structures involving the transfer of the collateral to a subsidiary or SPV at initiation or prior to any IDI default under the covered bond transaction.

The FDIC recognizes that some covered bond programs include mortgage-backed securities in limited quantities. Staff believes that allowing some limited inclusion of AAA-rated mortgage-backed securities as collateral for covered bonds during this interim, evaluation period will support enhanced liquidity for mortgage finance without increasing the risks to the deposit insurance fund. Therefore, covered bonds that include up to 10 percent of their collateral in AAA-rated mortgage securities backed solely by mortgage loans that are made in compliance with guidance referenced above will meet the standards set forth in the Policy Statement. In addition, substitution collateral for the covered bonds may include cash and Treasury and agency securities as necessary to prudently manage the cover pool. Securities backed by tranches in other securities or assets (such as Collateralized Debt Obligations) are not considered to be acceptable collateral.

The Policy Statement provides that the consent of the FDIC, as conservator or receiver, is provided to covered bond obligees to exercise their contractual rights over collateral for covered bond transactions conforming to the Interim Policy Statement no sooner than ten (10) business days after a monetary default on an IDI's obligation to the covered bond obligee, as defined below, or ten (10) business days after the effective date of repudiation as provided in written notice by the conservator or receiver.

The FDIC anticipates that future developments in the marketplace may present interim final covered bond structures and structural elements that are not encompassed within this Policy Statement and therefore the FDIC may consider future amendment (with appropriate notice) of this Policy Statement as the U.S. covered bond market develops.

IV. Scope and Applicability:

This Policy Statement applies to the FDIC in its capacity as conservator or receiver of an insured depository institution.

This Policy Statement only addresses the rights of the FDIC under 12 U.S.C. § 1821(e)(13)(C). A previous policy statement entitled "Statement of Policy on Foreclosure Consent and Redemption Rights," August 17, 1992, separately addresses consent under 12 U.S.C. § 1825(b), and should be separately consulted.

This Policy Statement does not authorize, and shall not be construed as authorizing, the waiver of the prohibitions in 12 U.S.C. § 1825(b)(2) against levy, attachment, garnishment, foreclosure or sale of property of the FDIC, nor does it authorize or shall it be construed as authorizing the attachment of any involuntary lien upon the property of the FDIC. The Policy Statement provides that it shall not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC to take any action or to exercise any power not specifically mentioned, including but not limited to any rights, powers or remedies of the FDIC regarding transfers taken in contemplation of the institution's insolvency or with the intent to hinder, delay or defraud the institution or the creditors of such institution, or that is a fraudulent transfer under applicable law.

The Board of Directors of the FDIC has adopted a final Covered Bond Policy Statement. The text of the Covered Bond Policy Statement follows:

COVERED BOND POLICY STATEMENT

Background

Insured depository institutions ("IDIs") are showing increasing interest in issuing covered bonds. Although covered bond structures vary, in all covered bonds the IDI issues a debt obligation secured by a pledge of assets, typically mortgages. The debt obligation is either a covered bond sold directly to investors, or mortgage bonds which are sold to a trust or similar entity ("special purpose vehicle" or "SPV") as collateral for the SPV to sell covered bonds to investors. In either case, the IDI's debt obligation is secured by a perfected first priority security interest in pledged mortgages, which remain on the IDI's balance sheet. Proponents argue that covered bonds provide new and additional sources of liquidity and diversity to an institution's funding base. Based upon the information available to date, the FDIC agrees that covered bonds may be a useful liquidity tool for IDIs as part of an overall prudent liquidity management framework and the parameters set forth in this policy statement. Because of the increasing interest IDIs have in issuing covered bonds, the FDIC has determined to issue this policy statement with respect to covered bonds.

(a) Definitions.

(1) For the purposes of this policy statement, a "covered bond" shall be defined as a non-deposit, recourse debt obligation of an IDI with a term greater than one year and no more than thirty years, that is secured directly or indirectly by perfected

security interests under applicable state and federal law on assets held and owned by the IDI consisting of eligible mortgages, or AAA-rated mortgage-backed securities secured by eligible mortgages if for no more than ten percent of the collateral for any covered bond issuance or series. Such covered bonds may permit substitution of cash and United States Treasury and agency securities for the initial collateral as necessary to prudently manage the cover pool.

(2) The term "eligible mortgages" shall mean performing first-lien mortgages on one-to-four family residential properties, underwritten at the fully indexed rate[6] and relying on documented income, and complying with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination. Due to the predictive quality of loan-to-value ratios in evaluating residential mortgages, issuers should disclose loan-to-value ratios for the cover pool to enhance transparency for the covered bond market.

(3) The term "covered bond obligation," shall be defined as the portion of the covered bond transaction that is the insured depository institution's debt obligation, whether to the SPV, mortgage bond trustee, or other parties.

(4) The term "covered bond obligee" is the entity to which the insured depository institution is indebted.

(5) The term "monetary default" shall mean the failure to pay when due (taking into account any period for cure of such failure or for forbearance provided under the instrument or in law) sums of money that are owed, without dispute, to the covered bond obligee under the terms of any bona fide instrument creating the obligation to pay.

(6) The term "total liabilities" shall mean, for banks that file quarterly Reports of Condition and Income (Call Reports), line 21 "Total liabilities" (Schedule RC); and for thrifts that file quarterly Thrift Financial Reports (TFRs), line SC70 "Total liabilities" (Schedule SC).

(b) Coverage. This policy statement only applies to covered bond issuances made with the consent of the IDI's primary federal regulator in which the IDI's total covered bond obligation as a result of such issuance comprises no more than 4 percent of an IDI's total liabilities, and only so long as the assets securing the covered bond obligation are eligible mortgages or AAA-rated mortgage securities on eligible mortgages, if not exceeding 10 percent of the collateral for any covered bond issuance. Substitution for the initial cover pool collateral may include cash and Treasury and agency securities as necessary to prudently manage the cover pool.

(c) Consent to certain actions. The FDIC as conservator or receiver consents to a covered bond obligee's exercise of the rights and powers listed in 12 U.S.C. § 1821(e)(13)(C), and will not assert any rights to which it may be entitled pursuant to 12 U.S.C. § 1821(e)(13)(C), after the expiration of the specified amount of time, and the occurrence of the following events:

(1) If at any time after appointment the conservator or receiver is in a monetary default to a covered bond obligee, as defined above, and remains in monetary default for ten (10) business days after actual delivery of a written request to the FDIC pursuant to paragraph (d) hereof to exercise contractual rights because of such monetary default, the FDIC hereby consents pursuant to 12 U.S.C. § 1821(e)(13)(C) to the covered bond obligee's exercise of any such contractual rights, including liquidation of properly pledged collateral by commercially reasonable and expeditious methods taking into account existing market conditions, provided no involvement of the receiver or conservator is required.

(2) If the FDIC as conservator or receiver of an insured depository institution provides a written notice of repudiation of a contract to a covered bond obligee, and the FDIC does not pay the damages due pursuant to 12 U.S.C. § 1821(e) by reason of such repudiation within ten (10) business days after the effective date of the notice, the FDIC hereby consents pursuant to 12 U.S.C. § 1821(e)(13)(C) for the covered bond obligee's exercise of any of its contractual rights, including liquidation of properly pledged collateral by commercially reasonable and expeditious methods taking into account existing market conditions, provided no involvement of the receiver or conservator is required.

(3) The liability of a conservator or receiver for the disaffirmance or repudiation of any covered bond issuance obligation, or for any monetary default on, any covered bond issuance, shall be limited to the par value of the bonds issued, plus contract interest accrued thereon to the date of appointment of the conservator or receiver.

(d) Consent. Any party requesting the FDIC's consent as conservator or receiver pursuant to 12 U.S.C. § 1821(e)(13)(C) pursuant to this policy statement should provide to the Deputy Director, Division of Resolutions and Receiverships, Federal Deposit Insurance Corporation, 550 17th Street, NW, F-7076, Washington DC 20429-0002, a statement of the basis upon which such request is made, and copies of all documentation supporting such request, including without limitation a copy of the applicable contract and of any applicable notices under the contract.

(e) Limitations. The consents set forth in this policy statement do not act to waive or relinquish any rights granted to the FDIC in any capacity, pursuant to any other applicable law or any agreement or contract. Nothing contained in this policy

alters the claims priority of collateralized obligations. Nothing contained in this policy statement shall be construed as permitting the avoidance of any legally enforceable or perfected security interest in any of the assets of an insured depository institution, provided such interest is not taken in contemplation of the institution's insolvency, or with the intent to hinder, delay or defraud the IDI or its creditors. Subject to the provisions of 12 U.S.C. § 1821(e)(13)(C), nothing contained in this policy statement shall be construed as permitting the conservator

or receiver to fail to comply with otherwise enforceable provisions of a contract or preventing a covered bond obligee's exercise of any of its contractual rights, including liquidation of properly pledged collateral by commercially reasonable methods.

(f) No waiver. This policy statement does not authorize, and shall not be construed as authorizing the waiver of the prohibitions in 12 U.S.C. § 1825(b)(2) against levy, attachment, garnishment, foreclosure, or sale of property of the FDIC, nor does it authorize nor shall it be construed as authorizing the attachment of any involuntary lien upon the property of the FDIC. Nor shall this policy statement be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC to take any action or to exercise any power not specifically mentioned, including but not limited to any rights, powers or remedies of the FDIC regarding transfers taken in contemplation of the institution's insolvency or with the intent to hinder, delay or defraud the institution or the creditors of such institution, or that is a fraudulent transfer under applicable law.

(g) No assignment. The right to consent under 12 U.S.C. § 1821(e)(13)(C) may not be assigned or transferred to any purchaser of property from the FDIC, other than to a conservator or bridge bank.

(h) Repeal. This policy statement may be repealed by the FDIC upon 30 days notice provided in the Federal Register, but any repeal shall not apply to any covered bond issuance made in accordance with this policy statement before such repeal.

By order of the Board of Directors
Dated at Washington, DC this _____ day of _____, 2008.
Federal Deposit Insurance Corporation

Robert E. Feldman
Executive Secretary

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1 For ease of reference, the Interim Final Covered Bond Policy Statement, published on April 23, 2008, will be referred to as the Interim Policy Statement. The Final Covered Bond Policy Statement will be referred to as the Policy Statement.

2 The FDIC understands that certain potential issuers may propose a different structure that does not involve the use of an SPV. The FDIC expresses no opinion about the appropriateness of SPV or so-called "direct issuance" covered bond structures, although both may comply with this Statement of Policy.

3 See 12 U.S.C. § 1821(e)(13)(C).

4 See 12 U.S.C. §§ 1821(e)(3) and (13). These provisions do not apply in the manner stated to "qualified financial contracts" as defined in Section 11(e) of the FDI Act. See 12 U.S.C. § 1821(e)(8).

5 See 12 U.S.C. §1821(e) (12).

6 The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JULIE L. WILLIAMS

Q.1. There are many differences between the U.S and European housing markets, which raises the question as to whether covered bonds would work as well in our markets as they have in Europe. What do you see as the primary differences between European and U.S. markets that this Committee must be aware of, and thoroughly examine, prior to the enactment of any policies in this area?

A.1. In Europe, covered bonds have facilitated mortgage financing through the capital markets for many years. Many European jurisdictions have a special law-based framework with a public supervisor specifically dedicated to setting uniform standards and regulating covered bonds. While differences exist among jurisdictions, certain essential common features of covered bonds are: (1) a bond collateralized by a "cover pool" of high quality assets; (2) supervised management of the cover pool; (3) covered bondholders have a priority claim on the cover pool collateral and also have recourse to the issuing institution; and (4) legislation providing certainty on the treatment of the covered bonds in an insolvency situation. The covered-bond market in Europe is the traditional and long-standing means of financing mortgages.

In contrast, U.S. institutions have had a number of alternatives for obtaining mortgage financing that are not available in Europe, such as Government-sponsored enterprises (GSEs) and the Federal Home Loan Banks (FHLBs). By creating the GSEs, the U.S. Government facilitated and promoted home ownership through mortgage lending. Through the GSEs, a secondary market for mortgages developed in the U.S. and, with the implicit Government backing, the GSEs were able to access the capital markets to fund their purchases of qualifying mortgage loans. By selling loans to the GSEs, financial institutions could obtain funding necessary to originate new loans. Fundamental questions are now being considered by U.S. policy makers on the future and purpose of the GSEs. In addition, the use of private-label securitization in the U.S. historically has played a large role in mortgage finance.

The FHLBs also have been a significant source of funding to the U.S. banking system. The FHLBs are 12 banks set up under a Government charter to provide support to the housing market by advancing funds to their member banks that make mortgages. The FHLB system issues debt to raise capital to provide the funding to loan originators. Recent developments stemming from the mortgage market disruption, however, are creating less certainty in obtaining advantageous FHLB funding, and impacting the availability of other historically perceived advantages, such as dividend payments and redemption of excess stock.

Before enacting covered-bond legislation, the Committee should carefully consider and examine the policy implications of covered bonds on other U.S. funding options. It is possible that covered bonds would enhance competition in the funding markets. For example, the HILBs would need to remain competitive with collateral coverage, haircuts, and cost of funds. The GSEs similarly would need to keep securitization terms competitive. Overall, competition is generally beneficial in promoting innovation in product structures and terms, including pricing competitiveness.

Covered bonds also present broad policy questions on issues related to housing finance that the Committee may wish to examine in more detail, including efforts to stabilize housing prices, increasing the availability of credit, improving underwriting standards, relying on the capital markets for housing finance and transitioning away from Government supported housing finance.

Q.2. In Mr. Campo's testimony he states that it is his belief that covered bonds will not lead to new lending, but rather banks would simply replace some of their whole loans activities with covered bonds. There also has been speculation, given the similarities between covered bonds and advances from the Federal Home Loan Banks, that a covered-bonds system simply would replace a portion of those advances.

Based upon your studies and experiences, do you believe a properly designed covered-bonds system to be a tool that will allow financial institutions to shift existing activity, or do you see this as additional activity that will increase funding, and thus lending?

A.2. A properly designed system of covered bonds would both shift the mix of funding away from other sources of funds and increase funding, as well as lending. However, the impact of covered bonds on credit provision should not be overstated, since there are many factors affecting the supply and demand for credit. A significant portion of the observed decline in bank lending has been demand related; business and consumers have cut back on spending. Looking at unused credit lines at banks, it appears there is a lot of available credit that business and consumers are not using. But it is also clear that bankers have generally tightened their underwriting standards—correcting practices that had become too lenient and responding to deteriorating economic and borrower conditions.

In general, the introduction of a new funding instrument like covered bonds tends to reduce an institution's funding costs by providing an additional vehicle for financing; it provides enhanced flexibility for an institution to identify the lowest cost funding alternative at any given time as market conditions evolve, and thus reduces the risk-adjusted cost of funds for issuing institutions.

An important consideration is whether covered bonds help to "complete" markets by providing a unique benefit. To succeed in the market, a financing alternative cannot be redundant, that is it must offer one or more features or characteristics that cannot be replicated by investors through other investments already available in capital markets. Covered bonds issued by banks (or by similar institutions) do present a unique combination of effective exposure from the perspective of bond investors, offering investors the risk-return possibilities associated with exposure to banking activities, while simultaneously providing that exposure in a form secured by an identifiable pool of bank-originated assets. Thus, it is reasonable to expect that covered bonds would be in demand, and, if so, should tend to reduce the risk-adjusted cost of funds for issuing institutions.

Other considerations are likely to affect this potential reduction in funding costs. Because the covering assets remain on an institution's balance sheet, the institution must hold more capital than in a typical securitization, and the required amount of capital may be

even higher under upcoming changes in capital rules. The relative benefits of covered bonds and securitization may also be affected by accounting changes and by risk-retention provisions in the recent Dodd-Frank Wall Street Reform and Consumer Protection Act.

However, if covered bonds on balance tend to reduce the cost of funds, they also would tend to lower the cost of, and increase the supply of, credit flowing from issuing institutions. This enhanced credit availability might be most prominent in the covering asset, since it would present a source of collateral for covered-bond issuance. However, credit expansion would not be limited to the covering asset alone, as all types of credit issued by an institution would benefit from an issuer's overall lower cost of funding.

The use of covered bonds would thus bring both a shift in the funding mix—due to the introduction of a currently unavailable funding alternative that at times would be the lowest cost of available funding alternatives—and an overall increase in funding (and many types of lending) by reducing the risk-adjusted cost of funding.

In addition to providing a nonredundant funding alternative that enhances the "completeness" of funding markets, covered bonds may provide additional benefits under current capital market conditions. One of the closest existing substitutes for covered bonds is securitization. Currently low levels of activity in most securitization markets leaves a sizable niche that covered bonds could fill. The extent of this apparent gap in currently available funding and investment instruments suggests that covered bonds might significantly boost lending: An important counterargument relates to capital charges. Because covered bonds remain on an institution's balance sheet, the institution must hold more capital than in a typical securitization. In addition, new accounting rules, upcoming changes in capital rules that may require higher levels of capital for assets held on a bank's balance sheet, and risk-retention provisions in the recent Dodd-Frank Wall Street Reform and Consumer Protection Act, could constrain the growth of the covered-bond market.

Q.3. If simply a shift, where do you see the shift occurring and why do you believe it beneficial, or not, under those circumstances?

A.3. As noted in the response to the previous question, the introduction of covered bonds would lead to a shift in the funding mix, to the extent that covered bonds present issuers with a less expensive alternative to existing funding vehicles. This shift likely would be away from all other alternatives to at least some degree, but the shift is likely to be relatively larger for alternatives that are closer substitutes, such as securitization.

However, in addition to such a shift in the mix of financing vehicles used by issuers, the availability of covered bonds as a funding alternative would also likely lead to an overall expansion of funding activity and credit extension by bond issuers.

Q.4. The implicit guarantee provided to Fannie Mae and Freddie Mac ultimately cost the American taxpayer hundreds of billions of dollars. Any changes we make to our home finance system must ensure that the taxpayers never again are exposed to this kind of a danger. If a covered-bond system was to be designed and enacted,

what components would be essential to ensure that the system did not carry this same implicit guarantee?

A.4. A critical component in designing a U.S. statutory covered-bond program is determining the consequences of a default of a covered-bond issuance or the failure of a covered-bond issuer. With respect to an issuing institution's insolvency, it is important that the legal framework clarify and specifically address what would happen to the cover pool, including the operation and management of the pool; the rights of the covered bondholders; and the responsibilities and obligations of the covered-bond regulator. The absence of any Government backing or guarantee could be affirmatively provided in the statutory framework creating tile resolution process.

Covered bonds provide for payment without any implicit or explicit Government involvement or guarantee because of their "dual recourse" feature. Covered bonds are backed by the issuing institution's promise to pay and by a dynamic pool of assets pledged as collateral, referred to as the cover pool. The collateral underlying this pool is actively managed to ensure ongoing performing assets, and segregated and managed for the benefit of covered bondholders. In a default or issuer insolvency situation, investors would look first to the institution to make payments on the bonds, but they also would have a claim against the cover pool that has priority over unsecured creditors. The covered bonds would not automatically accelerate if the issuing institution goes insolvent. If appropriate, issuers could be required to provide disclosures that covered-bond issuances are not guaranteed, insured, or backed by the U.S. Government.

Q.5. Many experts feel that it would be economies of scale that could make covered bonds a viable tool for liquidity. Therefore, there is some debate as to how or if community and regional banks would be able to participate in the covered-bonds market.

What is your opinion on the likelihood that covered bonds could be an effective tool for them and why do you believe this to be the case?

A.5. Similar to other funding sources, the institution's decision-making process should consider all costs and benefits of a covered-bond program relative to its potential issuance size. As noted in the OCC testimony, various types of standards could be embodied in a covered-bond regulatory framework that would remove obstacles to the development of this market. These standards and framework would naturally include compliance costs and burdens. For example, covered bonds should have minimum eligibility criteria setting asset quality standards to promote the inclusion of high quality assets in the cover pool. Requiring meaningful disclosures and making detailed information available about assets in a cover pool is essential to provide consistency and transparency across covered-bond issuances. Another important standard may include a designated minimum amount of overcollateralization and an asset coverage test and independent "asset monitor" to confirm on a periodic basis whether the asset coverage test is satisfied. My testimony notes that covered-bond regulators should have the authority to impose a cap in the percentage of particular asset types that issuing

institutions could use for the covered-bond program. In addition, an issuer's total covered-bond obligations as a percentage of the issuer's total liabilities also could be limited.

For a quality lender with prudent underwriting standards and sound risk management practices already in place, the incremental costs of a covered-bond program would likely be less. In general, the larger the issuance relative to these incremental costs, then the greater the potential benefit to the issuer.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM JULIE L. WILLIAMS

Q.1. What challenges are there to creating a resolution procedure in the case where an issuer fails?

A.1. The resolution procedure for the failure of a covered-bond issuer is a critical component in designing a U.S. statutory covered-bond program. Without a U.S. legal framework addressing the operation and management of the cover pool in the event of an issuer insolvency U.S. covered bonds will continue to lack predictability and clarity compared to other jurisdictions. With respect to an issuing institution's insolvency, it is important that the legal framework clarify and specifically address what would happen to the cover pool and the rights of the covered bondholders. In particular, if the issuer is an insured depository institution then consideration must be given to the FDIC's statutory role as conservator or receiver.

A statutory framework could create a structure with the following general components when the FDIC is appointed as conservator or receiver for an insolvent issuer: (1) creation of a separate estate and provision to the FDIC of an exclusive right for a certain designated period of time to transfer the issuer's covered-bond program to another eligible issuer; and (2) a requirement that the FDIC as conservator or receiver, during the time period, perform all monetary and nonmonetary obligations of the issuer until the FDIC completes the transfer of the covered-bond program, the FDIC elects to repudiate its continuing obligations to perform, or the FDIC fails to cure a default (other than the issuer's conservatorship or receivership). If the FDIC as conservator or receiver, does not timely effect a transfer of the covered-bond program to another eligible issuer, repudiates its continuing obligations to perform, or fails to cure a default, then the statutory framework could provide for the automatic creation of a separate estate and attendant responsibilities.

Specific challenges in creating a statutory framework relating to the resolution procedure include addressing the preservation of deficiency claims against the issuer, the creation of a residual interest that represents the right to any surplus from the cover pool, and the obligation of the issuer to transfer applicable books, records, files, and other documents to the covered-bond regulator or another designee. Consideration also should be given to statutory provisions providing that the covered-bond regulator may elect for an issuer to continue servicing the cover pool for some reasonable and operationally practical period of time, and whether the framework should provide for the Federal Reserve Banks or others to

make advances to the estate. If Federal Reserve advances are permitted, they should be for liquidity purposes, and should be subject to Federal Reserve rules that limit credit risk exposure.

A further specific challenge is determining the appropriate treatment of any excess amounts from the cover pool once the covered bondholders have been paid in full. For example, if a residual interest is created in the estate that represents the right to any surplus from the cover pool after the covered bonds and all other liabilities of the estate had been paid in full, should the FDIC or the covered bondholders receive the excess collateral?

Q.2. Who should be in charge of that resolution process?

A.2. A comprehensive approach for covered bonds that reflects a consistent and predictable process across the Federal financial regulators would serve to provide certainty and predictability to investors and the marketplace in cases of default and issuer insolvency. This type of framework would require the covered-bond regulator to act as or appoint a trustee of the separate estate, and to appoint and oversee a servicer or administrator for the cover pool held by the estate. If the issuer is an insured depository institution then consideration must be given to the FDIC's statutory role as conservator or receiver. Given the nature of the events triggering resolution procedures under a covered-bond framework, litigation by unhappy private parties could attempt to draw in the covered-bond regulator. As such, careful consideration should be given to addressing limitations on actions against, and recognition of sovereign immunity for, the covered-bond regulator acting in its statutorily designated capacities.

Q.3. How can that process be structured in order to prohibit losses from being absorbed by the taxpayer?

A.3. By structuring the resolution process to involve the creation of a separate estate that would exist and be administered separately from the issuing institution, the legal framework would not involve recourse to U.S. taxpayers. Covered bonds do not involve a Government guarantee or subsidy, and payments to the covered bondholders are not insured deposits. The distinctive features of covered bonds, unlike other secured debt, include backing by both the institution's promise to pay and a dynamic pool of assets pledged as collateral that comprises the "cover pool." The underlying assets are typically high quality assets, subject to various eligibility criteria and must be replaced by the institution should they fail to meet specified criteria. While investors look first to the institution to make payments on tile bonds, the investors also have a claim against the cover pool. In the event of insolvency, the separate estate is comprised of the applicable cover pool and assumes liability for the covered bonds and any related obligations secured by that cover pool.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MICHAEL H. KRIMMINGER

Q.1. In response to questioning during the hearing you indicated that the FDIC would price the additional risk posed by covered

bonds into the assessment fees the FDIC would charge institutions that issued covered bonds.

Does the FDIC believe issuing covered bonds increases the risk of failure to an institution? If so, please describe how the FDIC arrived at this decision, including a description of any data examined as part of the analysis.

A.1. If structured correctly, covered bonds could provide another tool for banks to either bolster liquidity or increase lending. However, overreliance on any type of secured borrowing, including covered bonds, makes it difficult for an institution to borrow in other ways. Overcollateralization requirements can increase the difficulty. Inability to borrow can cause liquidity problems that may make the institution more prone to failure during a significant downturn in the banking industry.

If a covered-bond transaction requires that an institution substitute good collateral for defaulting collateral, an increase in defaulting collateral will leave the institution with the defaulting loans, which will increase its risk of failure. With an overcollateralization requirement, either an increase in defaulting collateral or a decrease in the institution's general credit quality may trigger requirements for additional overcollateralization, again increasing the risk of failure.

Allowing an institution to include too wide a variety of assets as collateral in a covered-bond program (*e.g.,* collateral other than home mortgage loans) may encourage the institution to originate or acquire assets without proper underwriting and in businesses in which it has no experience, thus increasing the risk of an institution's failure. In particular, permitting derivatives or a large percentage of structured securities (such as collateralized debt obligations) as collateral can increase the risk of failure. Both derivatives and structured securities have been implicated in institution failures in recent years. Covered bonds secured by structured securities would be particularly risky if the collateral backing the structured securities were of a type not directly permitted as collateral for the covered bonds. This increased risk could come from either the collateral backing the structured securities itself or from a lack of knowledge concerning the underwriting standards for the collateral.

Q.2. Does the FDIC believe issuing covered bonds increases losses to the Deposit Insurance Fund (DIF), given a failure of an institution? If so, please describe how the FDIC arrived at this decision, including a description of any data examined as part of the analysis.

A.2. Unless covered-bond transactions are structured according to the principles contained in the FDIC's testimony, covered bonds could increase losses to the DIF. As discussed in response to the previous question, an improperly structured covered-bond transaction or overreliance on failure and the structured bonds or other secured financing can increase an institution's risk of risk of DIF losses.

Covered bonds also can increase the DIF's losses in the event of an institution's failure, if the covered-bond transaction is not structured according to the principles contained in the FDIC's testi-

mony. An increase in secured liabilities will increase losses to the DIF because it reduces the unpledged assets available for sale by the FDIC as receiver to repay the DIF for its insured depositor protection. As a result, if bondholders retain the excess collateral, this will further decrease the assets available for sale and thereby increase the losses that must be covered by the DIF. Specifically, if bondholders are given the option of retaining the collateral securing the covered bonds (rather than accepting payment) when an institution fails, the FDIC would only receive a residual certificate. As the result of its experience with asset securitizations and structured finance programs, the FDIC has discovered that it is difficult to sell residual certificates, even at deeply discounted prices. In contrast, when the FDIC pays secured creditors the secured value of their claim and redeems collateral after an institution fails, the DIF's losses are reduced.

Moreover, because losses would be allocated first to the residual certificate and because the retained collateral would be managed by an asset manager appointed by the bondholders for their benefit rather than the residual holder's benefit, the DIF could be exposed to additional losses. To forestall these possibilities, the FDIC as receiver should retain the ability to repudiate the covered bonds, pay the bondholders the outstanding principal and interest up to the date of payment, and take control of the collateral.

Finally, regardless of the structure of a covered-bond transaction, to the extent that an institution borrows on a secured basis rather than through unsecured, nondeposit borrowing, the DIF will suffer larger losses if the institution fails, all else equal, because of the priority of claims in a receivership. Secured liabilities must be paid in full before the FDIC receives any payment on its subrogated claim as the deposit insurer. Unsecured claims, on the other hand, receive no payment unless the FDIC has been completely reimbursed on its subrogated claim.

Q.3. If the FDIC prices any increased risk appropriately (whatever the rationale for the increase in risk) in the deposit insurance assessments, why would this not be sufficient to cover assets that would not be available to the FDIC if a covered-bond issuing institution were to be placed into receivership?

A.3. Because of the large number of insured institutions and because of the detailed information that institutions would have to provide the FDIC, the FDIC generally cannot determine assessment rates for an institution based on individual assets or liabilities and generally must rely on supervisory appraisals and statistical methods to price for risk. Thus, for example, while heavy reliance on secured borrowing will increase an institution's assessment rate, it would be difficult, and likely impossible, for supervisory appraisals or statistical methods to price for risk based on individual instances where an institution has borrowed on a secured basis, such as a specific covered-bond transaction. For the 100 or so largest institutions, the FDIC relies on a more detailed analysis of each institution's specific risk, but, even in these institutions, the FDIC cannot price for individual instances where an institution has borrowed on a secured basis.

Moreover, even if the FDIC was able to fully price for risk based on each instance where an institution has borrowed through a covered-bond transaction, the resulting assessment rate could be prohibitively high.

Q.4. In Mr. Campo's testimony he states that it is his belief that covered bonds will not lead to new lending, but rather banks would simply replace some of their whole loans activities with covered bonds. There also has been speculation, given the similarities between covered bonds and advances from the Federal Home Loan Banks, that a covered-bonds system simply would replace a portion of those advances.

Based upon your studies and experiences, do you believe a properly designed covered-bonds system to be a tool that will allow financial institutions to shift existing activity, or do you see this as additional activity that will increase funding, and thus lending?

A.4. Covered bonds could provide a useful alternative to traditional off-balance sheet funding, such as asset backed securitizations. However, the FDIC has not undertaken a formal study of this issue. The banking industry is currently highly liquid, thus liquidity issues are not restraining lending. In the future, if liquidity reverts to lower levels, covered bonds could have a more realistic chance of spurring lending or having a positive impact on banks' liquidity.

Q.5. If simply a shift, where do you see the shift occurring and why do you believe it beneficial, or not, under those circumstances?

A.5. It is difficult to isolate the effect of a single funding source on a bank's ability or willingness to lend. The extent that covered bonds would replace existing sources of liquidity, or will serve as a complimentary source, will depend on a wide variety of factors such as balance sheet capacity, accounting standards, investor appetite, the housing market, and the cost of unsecured sources of liquidity, including deposits and unsecured commercial paper. It is, however, reasonable to conclude that covered bonds are likely to substitute for other liquidity sources if they provide cheaper funding because the absolute volume of covered bonds for any institution is limited by its balance sheet since covered bonds are an on-balance sheet funding source.

Q.6. The implicit guarantee provided to Fannie Mae and Freddie Mac ultimately cost the American taxpayer hundreds of billions of dollars. Any changes we make to our home finance system must ensure that the taxpayers never again are exposed to this kind of a danger.

If a covered-bond system was to be designed and enacted, what components would be essential to ensure that the system did not carry this same implicit guarantee?

A.6. Unlike the bailouts of both Fannie Mae and Freddie Mac, resolutions of failed insured depository institutions as well as the DIF itself are not funded by taxpayers, but by the banking industry.

The FDIC would support covered-bond legislation that allows the receiver to essentially prepay the bonds (or repudiate) by paying the par value of outstanding bonds plus interest accrued through the date of payment. This provides a remedy that fully reimburses

the covered-bond investors. In return, as in any other repudiation, the FDIC as receiver would be entitled to retain the collateral in the cover pool after payment of those damages.

Similarly, balanced covered-bond legislation should avoid excessive governmental or regulatory involvement in protecting covered-bond investors. For this reason, the FDIC has recommended that legislation not have regulators enforcing overcollateralization or other covered-bond standards for the benefit of investors, rather than to preserve the safety and soundness of financial institutions. Similarly the FDIC has recommended that legislation not give regulators the duty to control any postdefault estate for the benefit of investors. Such entanglements provide a level of governmental protection for investors that could imply implicit guarantees—as has been the perception in some European covered-bond regulatory regimes.

The FDIC believes that transfer of covered bonds would minimize the disruption in the covered-bond markets. Therefore, legislation should provide for the authority to continue to perform under the covered bond until it can sell the program to another bank. This would not expose the investors to any loss, by definition, since the FDIC would meet all requirements of the covered-bond program, including replenishment of the cover pool and overcollateralization. As long as the FDIC is performing under a covered-bond agreement, covered-bond legislation should not limit the time in which the FDIC has to decide how best to proceed.

Any legislation that fails to preserve these important receivership authorities makes the FDIC the *de facto* guarantor of covered bonds and the *de facto* insurer of covered-bond bondholders.

Q.7. Many experts feel that it would be economies of scale that could make covered bonds a viable tool for liquidity. Therefore, there is some debate as to how or if community and regional banks would be able to participate in the covered-bonds market.

What is your opinion on the likelihood that covered bonds could be an effective tool for them and why do you believe this to be the case?

A.7. Economies of scale are needed in most existing covered-bond models. This suggests the principal users of covered bonds will be the largest institutions for the foreseeable future.

Q.8. There are many differences between the U.S. and European housing markets, which raises the question as to whether covered bonds would work as well in our markets as they have in Europe.

What do you see as the primary differences between European and U.S. markets that this Committee must be aware of, and thoroughly examine, prior to the enactment of any policies in this area?

A.8. Until the past decade, most *pfandbriefes* (the German form of covered bonds) were issued by the Landesbanks, which in turn were supported directly by the respective local governmental authorities. Even without direct support, there is significant indirect Government support for the European banking sector. By contrast, in the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act aims to reduce the support given by the taxpayers to the banking sector.

Assets securing European covered bonds have different terms and structures than U.S. assets. Residential mortgages, for example, in many jurisdictions, permit banks to reset interest rates, are of short duration (5 years), and have loan to value ratios that are low. Similarly, use of European models to use as a basis or even justification for use of other types of assets to secure covered bonds is not wise. For example, while public debt instruments have been used as collateral in European covered-bond programs, public debt instruments have very different characteristics and risks in the U.S. In European jurisdictions, public entities generally are not subject to an insolvency regime similar to Chapter 9 bankruptcy for local governments in the U.S. They also benefit from a fair amount of sovereign support and are unlikely to issue complex or short-term instruments such as tax anticipation notes or variable rate demand obligations.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM MICHAEL H. KRIMMINGER

Q.1. What challenges are there to creating a resolution procedure in the case where an issuer fails?

A.1. First and foremost, the flexibility of the FDIC as receiver in dealing with covered bonds must be maintained to avoid a subsidy of the covered-bond investors. That flexibility includes the ability to control a pool of collateral securing the covered bonds (the cover pool) as long as the FDIC performs under the covered bond. It also includes the authority to repudiate the covered bond (after paying par plus accrued interest) to maintain control of the cover pool. The Statement of Policy adopted by the FDIC's Board of Directors in 2008 provides a clear guide to the treatment of covered bonds in a receivership. The market's reaction to this Statement was very positive, and most commentators at the time it was proposed stated that it provided a solid foundation for the covered-bond market. At a minimum, the FDIC suggests that its Statement of Policy should serve as a framework for any legislation.

Q.2. Who should be in charge of that resolution process?

A.2. As we have consistently stated, we believe that resolution of a covered-bond program should not be separate from the resolution of the entire operations of the failed institution itself. The FDIC should retain its current flexibility to maximize recovery for the benefit of depositors and all creditors. If, in any resolution of an issuer, the FDIC determines to turn over the collateral to the investors, the administration of the collateral should remain a matter of private contract.

Q.3. How can that process be structured in order to prohibit losses from being absorbed by the taxpayer?

A.3. As noted above, to protect taxpayers and the bank-funded DIF, any legislation or regulatory initiative must maintain the FDIC's current flexibility in dealing with covered bonds, whether the FDIC is acting as receiver of insured depositories or systemically significant financial companies. Additionally, regulation of covered-bond programs should not entangle the Federal Government in the private contracts between issuers and investors to such an extent that

would imply a guarantee by the Government, as is the case in Europe.

We believe that H.R. 5823 creates a structure of regulation and oversight for the benefit of the investors that could imply that Federal regulators are responsible for ensuring that the issuing banks live up to their agreements under covered bonds. Moreover, H.R. 5823 also would make the Federal prudential regulators the appointing and supervising authority of trustees that would operate the covered-bond separate estates. This level of Government entanglement in private contractual matters could lead to the perception or even reality of an implied Government guarantee of covered bonds. An implied guarantee of covered bonds would put covered bonds on a near par with the Government sponsored enterprises—a status that should not be granted without strong policy reasons because of the risk posed to taxpayers.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM SCOTT A. STENGEL

Q.1. Mr. Stengel, some experts have pointed to Fannie Mae and Freddie Mac as major obstacles to covered bonds establishing a foothold in this country.

With that in mind, what changes do you feel would need to occur in any new secondary market structure to better allow for competition by covered bonds with the agency MBS market?

A.1. In May 2006, economists at the Federal Reserve valued the implicit Federal subsidy backing Fannie Mae and Freddie Mac at $189 billion.[1] At the time, only two U.S. financial holding companies even had market capitalizations in excess of that amount—Citigroup at $240 billion and Bank of America Corporation at $220 billion.

We can say without hyperbole, therefore, that no private-sector security of any kind can compete on an equal footing—in either the primary market or the secondary market—with the debt securities or the mortgage-backed securities of Fannie Mae, Freddie Mac, or any other Government-Sponsored Enterprise (GSE) that enjoys an implicit full-faith-and-credit guarantee.

Looking ahead to GSE reform, we believe that two principles should be observed in the context of U.S. covered bonds.

First, with nearly every reform proposal contemplating some form of Federal subsidy for the secondary mortgage market, the legislative framework for covered bonds must optimize cost efficiency in order to level the playing field. This implicates all of the structural elements that were proposed in my written testimony, with a particular emphasis on the following:

- a broad range of eligible asset classes (including ones that encompass consumer loans like credit-card loans and auto loans),
- a separate resolution process that is unequivocal and nondiscretionary, that cannot be undermined by conflicts of interest (including the FDIC's inherent conflict with covered-bond in-

[1] Wayne Passmore, *et al.,* Federal Reserve Research on Government-Sponsored Enterprises: Presentation at the Federal Reserve Bank of Chicago Bank Structure Conference 11 (May 18, 2006). A copy is attached as Exhibit A.

vestors), and that permits nondiscriminatory access to liquidity from the Federal Reserve Banks, and

- a seamless incorporation of relevant tax and securities laws.

Such a framework, in our view, is essential to achieve several public-policy objectives that are crucial to financial stability: (1) more stable long-term liquidity, (2) less expensive and more available credit for consumers, small businesses, and the public sector, (3) diversified and additive funding for financial institutions, (4) private-sector capital with no taxpayer support, (5) more strongly aligned incentives, and (6) increased transparency and uniformity in the capital markets.

Second, if Congress were to enact a catastrophic Federal-guarantee program like that suggested by the Housing Policy Council in its reform proposal, covered bonds should be eligible alongside securities issued by the newly created mortgage-securities insurance companies.[2] As already noted, private-sector securities can never be positioned to compete fully with those that carry either an explicit or an implicit Federal guarantee. While we expect traditional nonguaranteed covered bonds to flourish in the United States, they will be in their infancy when GSE reform is implemented. Uncertainty about the interaction of these two markets, in our view, counsels in favor of preserving optionality. In what will be a radically reshaped environment for mortgage finance, there might well be systemic value in covered bonds that can be guaranteed against catastrophic macroeconomic risk.

Q.2. In Mr. Campo's testimony he states that it is his belief that covered bonds will not lead to new lending, but rather banks would simply replace some of their whole loans activities with covered bonds. There also has been speculation, given the similarities between covered bonds and advances from the Federal Home Loan Banks, that a covered-bonds system simply would replace a portion of those advances.

Based upon your studies and experiences, do you believe a properly designed covered-bonds system to be a tool that will allow financial institutions to shift existing activity, or do you see this as additional activity that will increase funding, and thus lending?

If simply a shift, where do you see the shift occurring and why do you believe it beneficial, or not, under those circumstances?

A.2. Each individual decision to lend is a function of return on capital, business strategy, and risk management.

Covered bonds enable financial institutions (1) to lower the cost of funding, which increases the return on capital, (2) to augment rather than cannibalize their funding sources, which provides the fuel for business lines to innovate and boost lending, and (3) to better match assets and liabilities, which reduces the risk of providing longer-term closed-end loans (like residential mortgage loans) and revolving lines of credit (like credit-card loans).

As a result, we must respectfully disagree with the belief that covered bonds will not contribute to increased lending. That, in our

[2] The Future of Housing Finance: A Review of Proposals To Address Market Structure and Transition Before the House Committee on Financial Services, 111th Congress (2010) (statement of Michael J. Heid, Chairman, Housing Policy Council of the Financial Services Roundtable). A copy is attached as Exhibit B.

view, is not supported by the microeconomic incentives that drive the business of banking or by any empirical data.

We also must take issue with the premise that covered bonds are similar or equivalent to advances from the Federal Home Loan Banks (the FHLBs). First, covered bonds will fund a much broader range of asset classes than the FHLBs typically accept in the normal course of business. Second, covered bonds will supply fixed-rate liquidity with maturities that the FHLBs generally do not offer to their member institutions. For these reasons, we envision covered bonds as a private-sector complement, rather than as a substitute, for federally subsidized FHLB advances.

All of this being said, we can foresee financial institutions reallocating a modest portion of their short- and medium-term funding away from existing sources and toward a U.S. covered-bond market that is deep and liquid. But this, in our view, is the very macroeconomic objective that policy makers are seeking to achieve. The liquidity crisis that began in late 2008 was exacerbated in no small part by an overreliance on volatile short-term borrowings to fund long-term assets. Covered bonds will provide financial institutions with a cost-effective source of fixed-rate funding much farther out on the maturity curve than is currently feasible, which will lessen systemic risk in the broader financial markets and will bolster risk-management frameworks inside individual institutions.

Q.3. The implicit guarantee provided to Fannie Mae and Freddie Mac ultimately cost the American taxpayer hundreds of billions of dollars. Any changes we make to our home finance system must ensure that the taxpayers never again are exposed to this kind of a danger.

If a covered-bond system was to be designed and enacted, what components would be essential to ensure that the system did not carry this same implicit guarantee?

A.3. The implicit Federal guarantee enjoyed by Fannie Mae, Freddie Mac, and the FHLBs has arisen from an extraordinarily unique set of components:

- Each GSE has been federally chartered with a targeted public-policy purpose. [3]
- The U.S. Treasury has been authorized to extend credit to each GSE. [4]
- Each GSE has been exempted from most State and local income tax. [5]
- Each GSE's debt securities and mortgage-backed securities have been made eligible for open-market purchases by the Federal Reserve Banks, [6] for deposits of public funds, [7] and for investments by fiduciaries. [8]

[3] 12 U.S.C. §§1716-1717 (Fannie Mae), 1452–1454 (Freddie Mac), and 1423–1430c (FHLBs).
[4] 12 U.S.C. §§1719(c) (Fannie Mae), 1455(c) (Freddie Mac), and 1431(i) (FHLBs).
[5] 12 U.S.C. §§1723a(c)(2) (Fannie Mae), 1452(e) (Freddie Mac), and 1433 (FHLBs).
[6] 12 U.S.C. §355(2) and 12 C.F.R. §201.108(b) (Fannie Mae, Freddie Mac, and FHLBs).
[7] 12 U.S.C. §§1723c (Fannie Mae), 1452(g) (Freddie Mac), and 1435 (FHLBs).
[8] 12 U.S.C. §§1723c (Fannie Mae), 1452(g) (Freddie Mac), and 1435 (FHLBs); see also 15 U.S.C. §77r-1(a) (preempting any contrary State law in connection with the securities of Fannie Mae and Freddie Mac).

- Each GSE's debt securities and mortgage-backed securities have been exempted from investment limits that are otherwise imposed on banks, savings associations, and credit unions. [9]
- Each GSE has been entitled to use any Federal Reserve Bank as its depository, custodian, and fiscal agent. [10]

Under the legislative framework proposed in my written testimony, no issuer of U.S. covered bonds could lay claim to any status or preference that even remotely resembles those afforded to the GSEs. For example, to the extent that any misguided inference could be drawn from a covered-bond estate inheriting an insolvent issuer's access to liquidity from the Federal Reserve Banks, we have proposed that legislation expressly provide that (1) no advance can be made by a Federal Reserve Bank for the purpose, or with the expectation, of absorbing credit losses on the estate's cover pool, (2) any advance must have a maturity that is consistent with an advance for liquidity only, (3) repayment of any advance must constitute a superpriority claim against the estate that is secured by a superpriority lien on the cover pool, and (4) any Federal Reserve Bank making an advance must promptly report to Congress on the circumstances giving rise to the advance, the terms of the advance, the nature of the cover pool securing the advance, and the basis for concluding that credit losses on the cover pool will not be absorbed by the Federal Reserve Bank.

Some have suggested that the mere existence of a single covered-bond regulator could imply that covered bonds are backed to some degree by the U.S. Government. This, in our view, is a questionable proposition. After all, a single regulator—the Comptroller of the Currency (OCC)—supervises all national banks, but no one could seriously argue that the OCC is an implied-in-fact guarantor of their obligations. Similarly, the Securities and Exchange Commission regulates all nonexempt offers and sales of securities but certainly could not be perceived as insuring investors against any loss.

Our reservation about multiple covered-bond regulators, as some have proposed, is rooted in a conviction that market fragmentation would likely doom U.S. covered bonds from the outset. We cannot envision a deep and liquid market developing if national banks, State member banks, State nonmember banks, bank holding companies, and other covered-bond issuers are operating under different regulatory frameworks. At a minimum, therefore, we recommend that the Secretary of the Treasury be directed to promulgate a single set of regulations for all covered-bond issuers and that each of the individual prudential regulators be tasked with implementing them for the issuers under their supervision. This, in our view, would not be ideal but at least would allow for the kind of uniform legal regime that will be critical to developing a vibrant market for U.S. covered bonds.

We also are aware of the FDIC's recent assertion that the legislative framework proposed in my written testimony would give covered bondholders "a superpriority in receivership" and would result

[9] 12 U.S.C. §§24(Seventh), 335, 1464(c)(1), and 1757(7) (Fannie Mae, Freddie Mac, and FHLBs).

[10] 12 U.S.C. §§1723a(g) (Fannie Mae), 1452(d) (Freddie Mac), and 1435 (FHLBs).

in their claims being "essentially back-stopped by the FDIC."[11] These statements, however, were not substantiated and, in our view, reflect a fundamental misunderstanding of the proposal and existing law.

A superpriority claim or a superpriority lien, in the context of an insolvency proceeding, is one that has been elevated to a level of priority higher than that otherwise afforded by applicable law to other claims or liens (including administrative claims or liens).[12]

Nothing in our proposed legislative framework, including the treatment of any claim or lien of a covered bondholder, would change the priority scheme in a conservatorship or receivership of the issuing institution. Both before and after the insolvency proceeding, investors would benefit from a first-priority lien on the issuer's cover pool to secure their claims under the covered bonds—just like any other secured creditor—and at no time would they be entitled to a lien (superpriority or otherwise) on any of the issuer's other assets. In addition, to the extent that the cover pool proves insufficient to satisfy their claims in full, covered bondholders would fall in line alongside all other general unsecured creditors without any enhanced priority or preference of any kind. This treatment stands in stark contrast, for example, to the superpriority claims and liens that can arise in connection with postinsolvency financing arrangements[13] and to the springing priority of an FHLB's "super lien" on all of a member institution's property.[14]

What our legislative proposal would affect is the FDIC's power to compel an acceleration of the covered bonds and to pay only "actual direct compensatory damages . . . determined as of the date of the appointment of the conservator or receiver."[15] Because a *sine qua non* of covered bonds is their limited risk of prepayment, they instead would remain outstanding according to their original terms

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[11] Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Keynote Address to the Mortgages and the Future of Housing Finance Symposium (Oct. 25, 2010).

[12] *See, e.g.,* 11 U.S.C. §364(c) and (d) (in a bankruptcy case, authorizing postpetition loans "with priority over any or all administrative expenses" and "secured by a senior or equal lien on property of the estate that is subject to a lien"); 12 U.S.C. §4617(i)(11) (for a limited-life regulated entity created by the Federal Housing Finance Agency with respect to Fannie Mae, Freddie Mac, or an FHLB, authorizing loans "with priority over any or all of the obligations of the limited-life regulated entity" and "secured by a senior or equal lien on property of the limited-life regulated entity that is subject to a lien (other than mortgages that collateralize the mortgage-backed securities issued or guaranteed by an enterprise)"); Section 210(b)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) ("In the event that the [FDIC], as receiver for a covered financial company, is unable to obtain unsecured credit for the covered financial company from commercial sources, the Corporation as receiver may obtain credit or incur debt on the part of the covered financial company, which shall have priority over any or all administrative expenses of the receiver under paragraph (1)(A)."); Section 210(h)(16) of the Dodd-Frank Act (for a bridge financial company created by the FDIC with respect to a covered financial company, authorizing loans "with priority over any or all of the obligations of the bridge financial company" and "secured by a senior or equal lien on property of the bridge financial company that is subject to a lien").

[13] *See,* the authorities cited in note 12.

[14] 12 U.S.C. §1430(e) ("Notwithstanding any other provision of law, any security interest granted to a Federal Home Loan Bank by any member of any Federal Home Loan Bank or any affiliate of any such member shall be entitled to priority over the claims and rights of any party (including any receiver, conservator, trustee, or similar party having rights of a lien creditor) other than claims and rights that—(1) would be entitled to priority under otherwise applicable law; and (2) are held by actual bona fide purchasers for value or by actual secured parties that are secured by actual perfected security interests."); see also 12 U.S.C. §§1821(d)(5)(D) (precluding the FDIC from disallowing any claim asserted by an FHLB) and 1821(e)(14) (exempting FHLB advances from the FDIC's authority to disallow or repudiate contracts).

[15] 12 U.S.C. §1821(e)(1) and (3).

so long as collections and other proceeds from the cover pool could continue to fund all scheduled payments.

This, however, hardly creates a backstop by the FDIC. To the contrary, our proposal is a more modest iteration of the framework that currently exists for qualified financial contracts (QFCs) under the Federal Deposit Insurance Act (FDIA). One notable similarity between them is full restitution, at least to the extent of the posted collateral (including any overcollateralization), for damages that result from reinvestment risk. In the context of QFCs, this is picked up by the counterparty's right under the FDIA to "normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims."[16] Another similarity is found in carefully drawn limits on the FDIC's ability to repudiate or assign contracts or collateral.[17] But, unlike covered bondholders in our proposed framework, a QFC counterparty is entitled to even more, including (1) a unilateral right to terminate, liquidate, or accelerate the QFC and to exercise remedies and rights of setoff under the QFC and against any related collateral,[18] (2) an ability, after the business day following the date of the FDIC's appointment as receiver, to enforce ordinarily nonbinding contractual provisions that are triggered solely by the institution's insolvency or receivership (*ipso facto* clauses),[19] and (3) immunity from all avoidance actions except for those grounded in an actual intent to defraud.[20]

Still, as I noted in oral testimony during the hearing, we may be able to support a legislative framework for U.S. covered bonds that is modeled on these QFC provisions if the use of existing precedent would assuage even misplaced concerns.

Q.4. Many experts feel that it would be economies of scale that could make covered bonds a viable tool for liquidity. Therefore, there is some debate as to how or if community and regional banks would be able to participate in the covered-bonds market.

What is your opinion on the likelihood that covered bonds could be an effective tool for them and why do you believe this to be the case?

A.4. Covered bonds are a conservative and defensive investment that appeals to investors only if the secondary market is sufficiently deep and liquid to generate active bids, offers, and trades. As a result, each series of covered bonds is typically sized at no less than $500 million.

To ensure that regional and community banks are able to access such a market on competitive terms, we have proposed that pooled issuances be permitted. Under this arrangement, several institutions would issue more modestly sized series of covered bonds to a statutory trust or other separate entity that they have collectively sponsored. This entity then would populate a cover pool with the multiple series that have been acquired and issue into the market a single series of covered bonds backed by all of them together.

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[16] 12 U.S.C. §1821(e)(3)(C).
[17] 12 U.S.C. §1821(e)(9) and (11).
[18] 12 U.S.C. §1821(e)(8)(A) and (E).
[19] 12 U.S.C. §1821(e)(10)(B).
[20] 12 U.S.C. §1821(e)(8)(C).

In this way, for example, each of 10 community banks could establish its own separate covered-bond program comprised of the commercial-mortgage loans on its balance sheet and issue $50 million of related covered bonds to a jointly sponsored trust. All 10 of these separate $50 million series of covered bonds then would fill a cover pool established by the trust, and a single $500 million series of covered bonds backed by the entire cover pool would be issued by the trust to investors.

We believe that this approach, which has been used successfully in Europe, would open the U.S. covered-bond market to regional and community banks in a meaningful way. We also believe that the cost-effective, long-term funding that covered bonds can supply would be especially valuable to small- and middle-market institutions that historically have been limited to fewer and less diverse sources of liquidity.

Federal Reserve Research on Government-Sponsored Enterprises

Wayne Passmore, Gillian Burgess, Diana Hancock,
Andreas Lehnert, and Shane M. Sherlund

Presentation at the Federal Reserve Bank of Chicago
Bank Structure Conference
May 18, 2006

The opinions, analysis, and conclusions of these papers are solely those of the authors and do not necessarily reflect those of the Board of Governors of the Federal Reserve System.

Federal Reserve Papers

- My presentation will summarize the findings of five research papers.
- This research represents over a decade of work.
- Results have been subject to many tests for robustness.
- More GSE research will be forthcoming.

Introduction

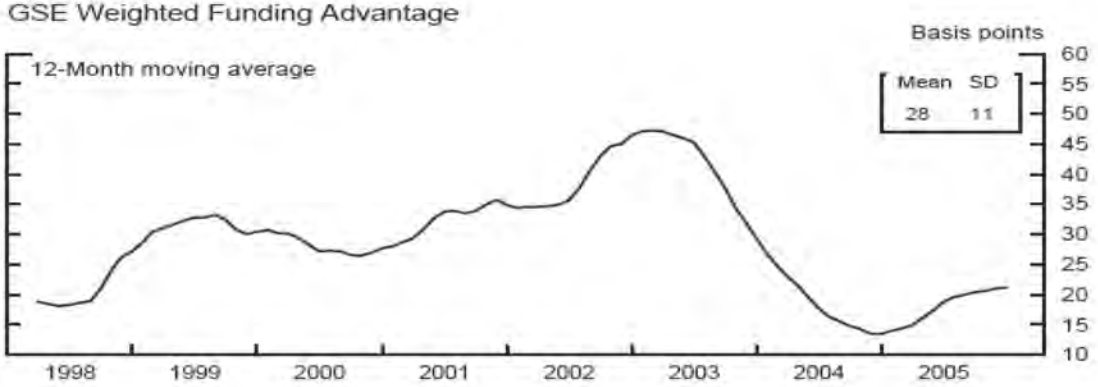
- Congress created the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) to enhance secondary mortgage markets (hereafter referred to as GSEs).
- They enhance secondary markets mainly through mortgage securitization.
- GSEs also issue debt to finance the purchase of their own MBS.
- Purchasers of their debt assume that the government provides the GSEs with a government guarantee, even though Congress has made no explicit promise to guarantee such debt.

What Is the Source of GSE Subsidy?

Funding Advantage:

- The difference between the interest rates paid on private corporate debt and the rates paid by the GSEs is a measure of the implicit subsidy.
- GSEs have little reason to transmit the subsidy to mortgage originators and, even if they did, it•s not clear originators would pass it on to borrowers in the form of lower rates.
- Subsidy transmission depends on the competition among GSEs and among the mortgage originators.
- Investors• perception of a government guarantee suggests absence of market discipline in GSE senior debt financing and a supernormal return on equity for GSEs.

GSE Weighted Funding Advantage



- Funding advantage is greater earlier in the period.
- In recent years, the funding advantage has been lower. This reflects lower credit risk premiums.
- Spreads on bank debt over Treasuries have narrowed quite a bit recently.
- Implicit guarantee is less valuable when credit risk premiums are historically low.

5

How to Measure the GSEs' Effect on Mortgage Rates?

- The GSEs can only buy mortgages below the conforming loan limit ($417,000 for a single-family mortgage in 2006).
- A private market for mortgages above this size, the jumbo market, accounts for about 14 percent of the entire mortgage market.
- Funders of jumbo mortgages either fund mortgages directly or use private-market mortgage securitization.
- We can compare jumbo mortgage rates to conforming mortgage rates to get a sense of the difference GSEs make in mortgage rates.
- Many studies use the jumbo-conforming spread only as the measure of the GSEs' effect, but this is an incomplete measure because there are many other factors.

Many Factors Influence the Jumbo-Conforming Spread

- ✓ GSE funding advantage
- ✓ Mortgage risk characteristics (prepayment and credit risks)
- ✓ Different mortgage demands in jumbo and conforming markets
- ✓ Different capacity to service mortgages
- ✓ Alternative investments available to originators
- ✓ Technological differences

- We use proxies to measure these factors and estimate their influences on the jumbo-conforming spread.
- These proxies show that factors other than the GSE funding advantage are important in determining the jumbo-conforming spread.

How Do We Estimate the GSE Influence on Mortgage Rates?

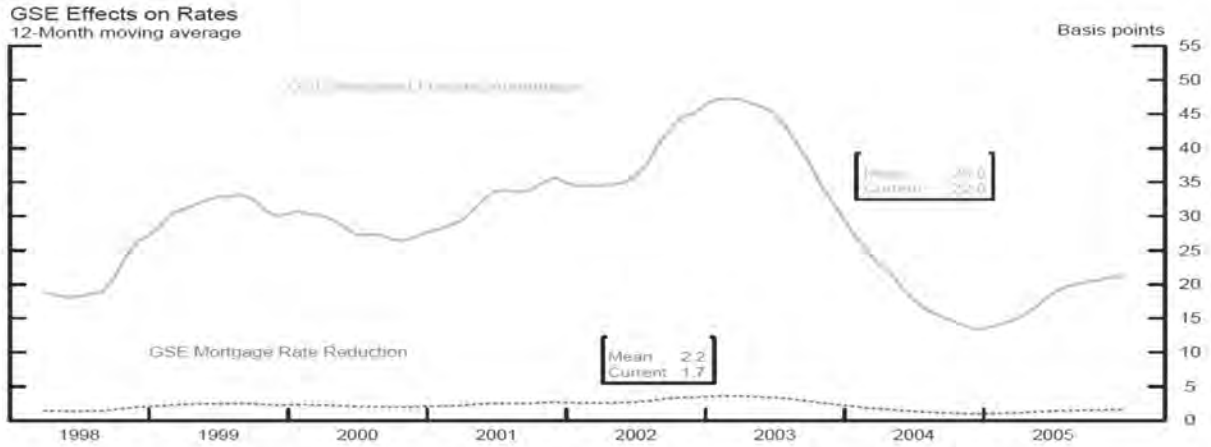
- The jumbo mortgage rate is around 15 basis points above the conforming mortgage rate (the jumbo-conforming spread).

- How much of the jumbo-conforming spread is the result of the GSEs• borrowing advantage?

- How much is due to other factors?

  Currently, our best estimate: about 5 percent of the GSE borrowing advantage flows through to mortgage rates.

  Implies a median reduction of less than 2 basis points over the April 1997-September 2005 period. Estimate in earlier research was 7 basis points.



- Funding advantage remains much larger than mortgage rate reduction.
- Funding advantage still implies substantial profits for GSE shareholders.
- Current estimates of the mortgage rate reduction are not statistically different than zero.

9

GSE Subsidy Calculation

- How much would investors pay for the GSE funding advantage if the charter was put up for auction?
- Based on historical combinations of the debt growth rate, GSE funding advantage, GSE mortgage rate reductions, Treasury yield curves, and equity premiums.
- We project cash flows from GSE funding advantage over 25 years, and then discount and sum them to get estimated subsidy value.
- Almost 3,000 simulations.

Table 1

Estimates of Present Value of GSE Subsidy

Billions

Elements of Subsidy	Mean (Earlier Paper)	Mean (Updated Estimates)
1. GSE Debt Subsidy	126	153
2. GSE MBS Subsidy	25	36
3. GSE Gross Subsidy	151	189
4. Homeowner Savings	32	15
5. Taxpayer Recapture	39	49
6. GSE Net Subsidy	80	125
Memo:		
7. Percent Retained	53	66
8. Net Subsidy as Percent of Market Value	67	118

- Subsidy estimates are unchanged, given the statistical confidence intervals.
- Recent simulations suggest high growth potential for GSE portfolios.
- Stock price is low relative to a cash-flow valuation of charter•s advantages.

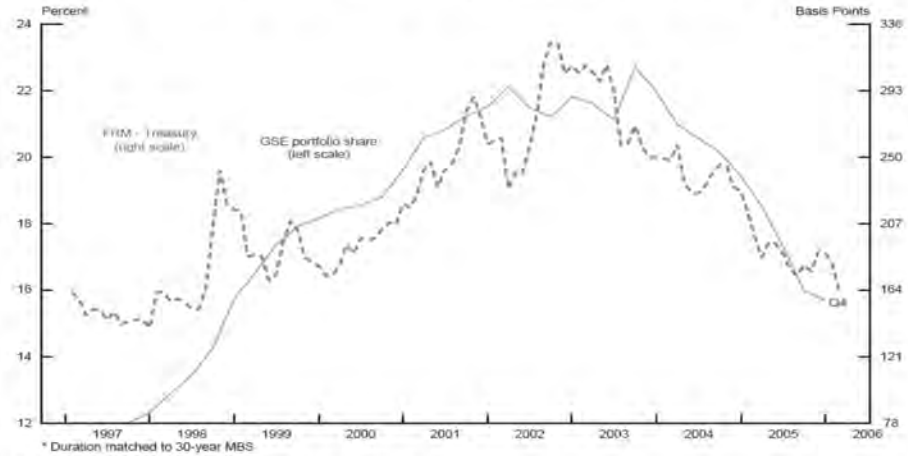
What are the Other Effects of GSE Debt Subsidy?

- Funding advantage translates into an incentive to issue debt and then purchase and hold higher-yielding assets.
- GSE portfolios are highly leveraged.
- Current mortgage system relies mainly on Fannie and Freddie for mortgage interest rate risk management.
- Concentration of risk combined with large size of the GSEs portfolios raises concerns about the risks to the financial system.

Is the portfolio really needed to carry out the GSEs' mission?

- Any expansion or contraction of GSE portfolios does not affect the level of total home mortgage debt outstanding.
- Total home mortgage debt level determined by supply and demand in primary market.
- GSE securitization provides mortgage originators with liquidity for the home mortgage market.
- Whether the GSEs subsequently purchase the securities for their portfolios or let them trade freely in public markets, liquidity is not affected.
- Implies that the GSE portfolios have no effect on primary mortgage rates; no offsetting benefits for concentration of interest rate risk.

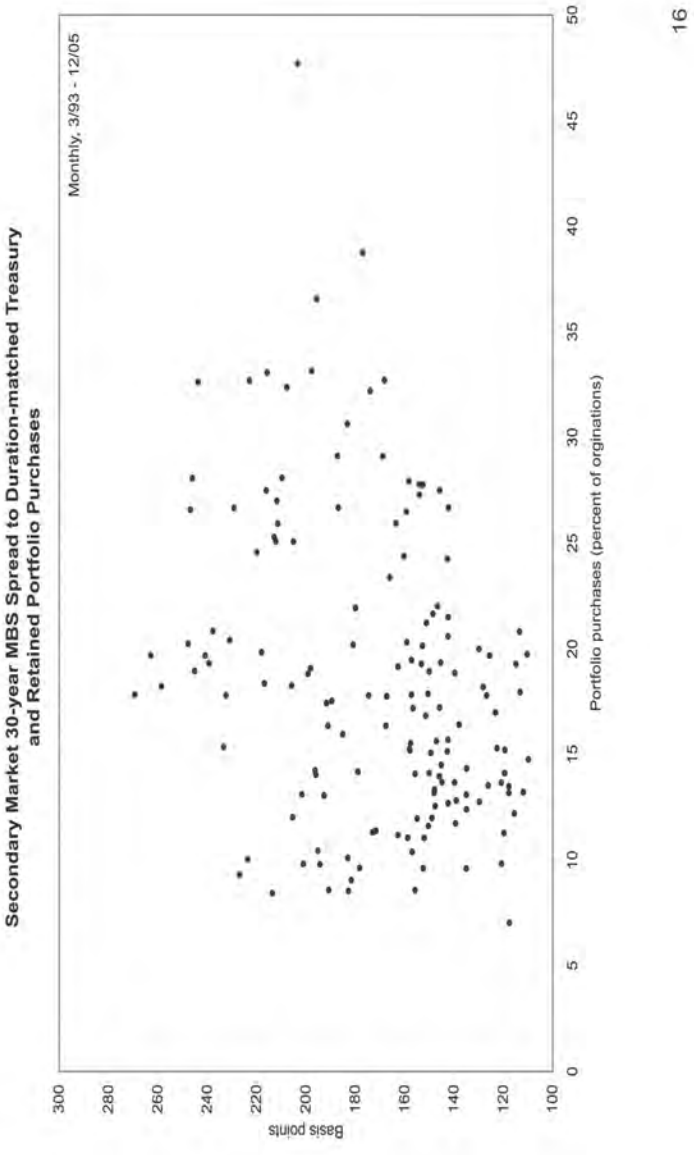
30-year FRM Rate Spread to Duration-matched* Treasury and GSE Market Share of Single-Family Mortgage Debt



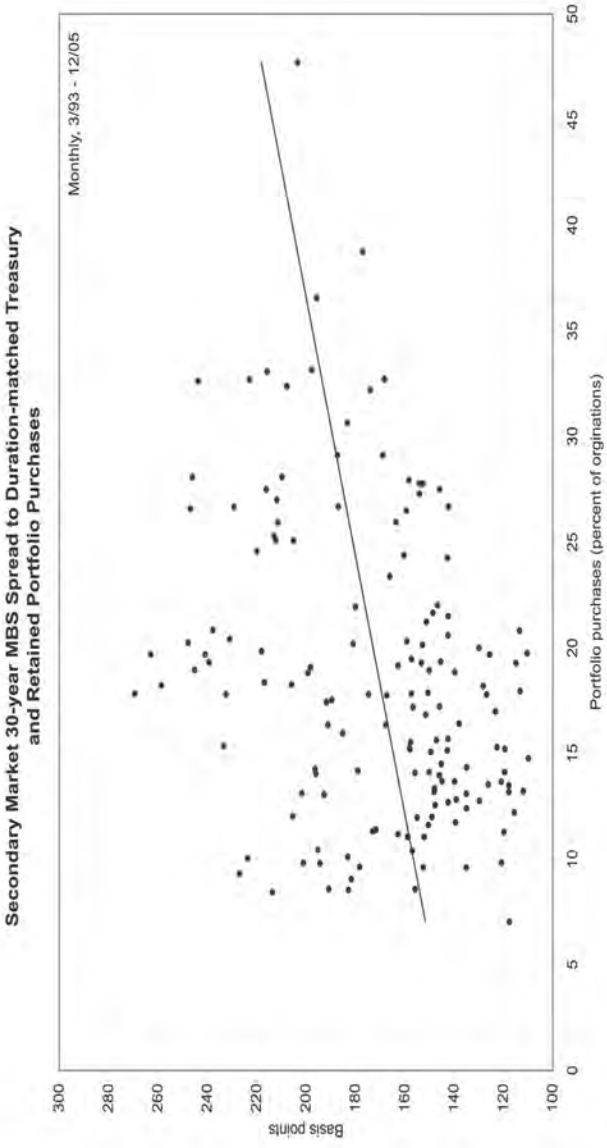
- When GSE share rises, spread rises.
- When GSE share falls, spread falls.
- Data do *not* support that GSEs' actions narrow spread during normal times.

The 1998 Liquidity Crisis

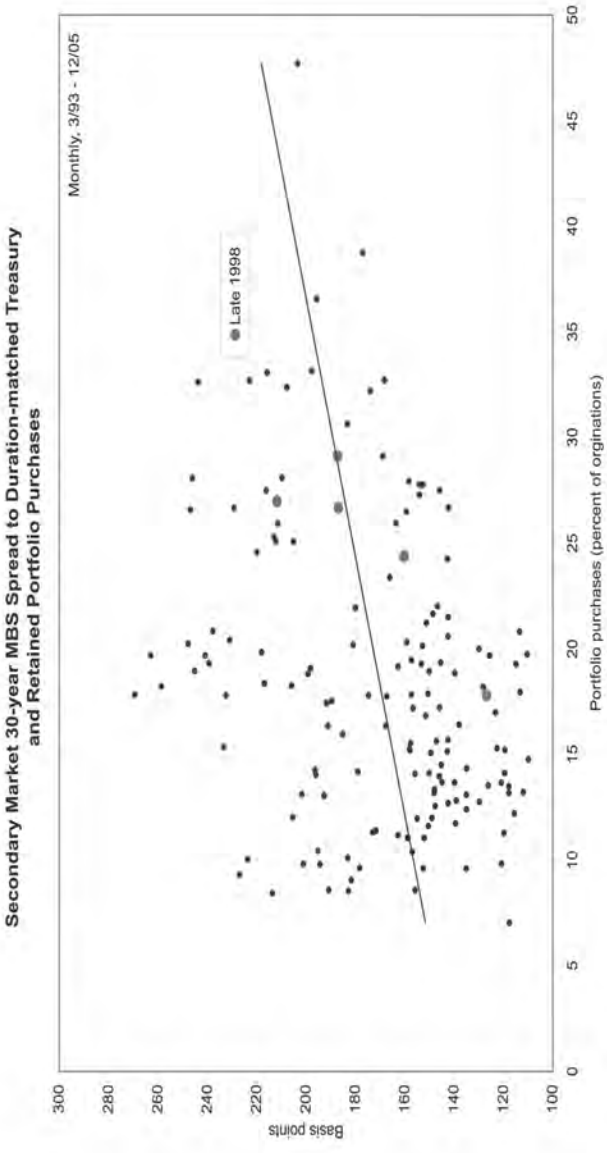
- Secondary mortgage market spreads increased during the fall of 1998, as did GSE portfolio purchases.
- Our model predicts the events during the fall of 1998 well; secondary market spreads widened and GSE portfolio purchases increased.
- Even had GSE portfolio purchases been unresponsive to wider spreads, our model suggests that secondary market spreads would have widened then contracted similarly to what actually occurred.
- Result is robust to many alternative specifications.
- Therefore GSEs do *not* reduce spreads during abnormal times, either.


Secondary Market 30-year MBS Spread to Duration-matched Treasury and Retained Portfolio Purchases
Monthly, 3/93 - 12/05
Basis points
300
280
260
240
220
200
180
160
140
120
100
0
5
10
15
20
25
30
35
40
45
50
Portfolio purchases (percent of orginations)

16



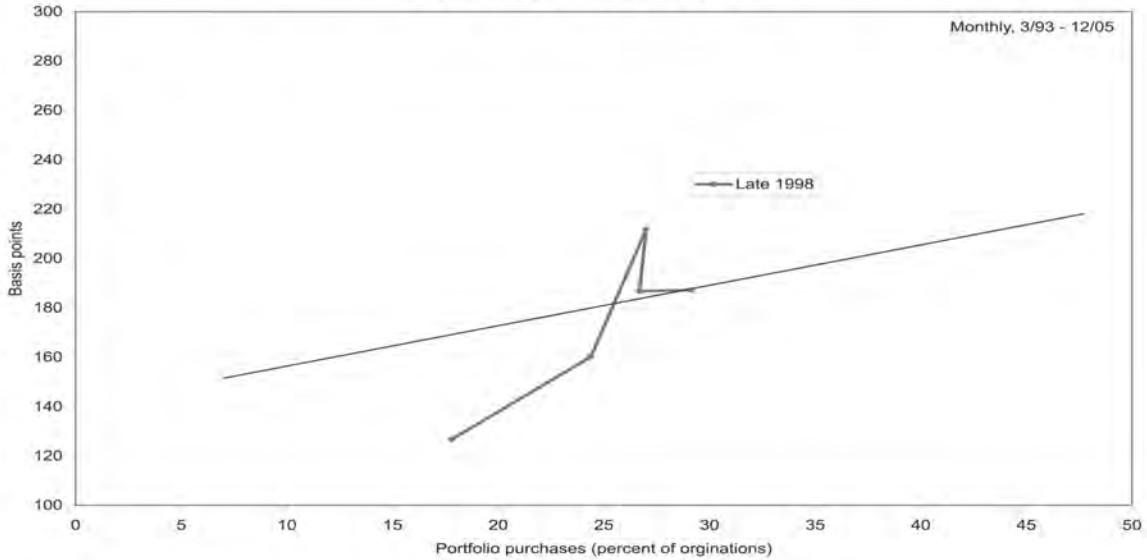
- Positive relationship between spreads and GSE purchases.



- Positive relationship between spreads and GSE purchases.
- Actual spreads widen in 1998;

18

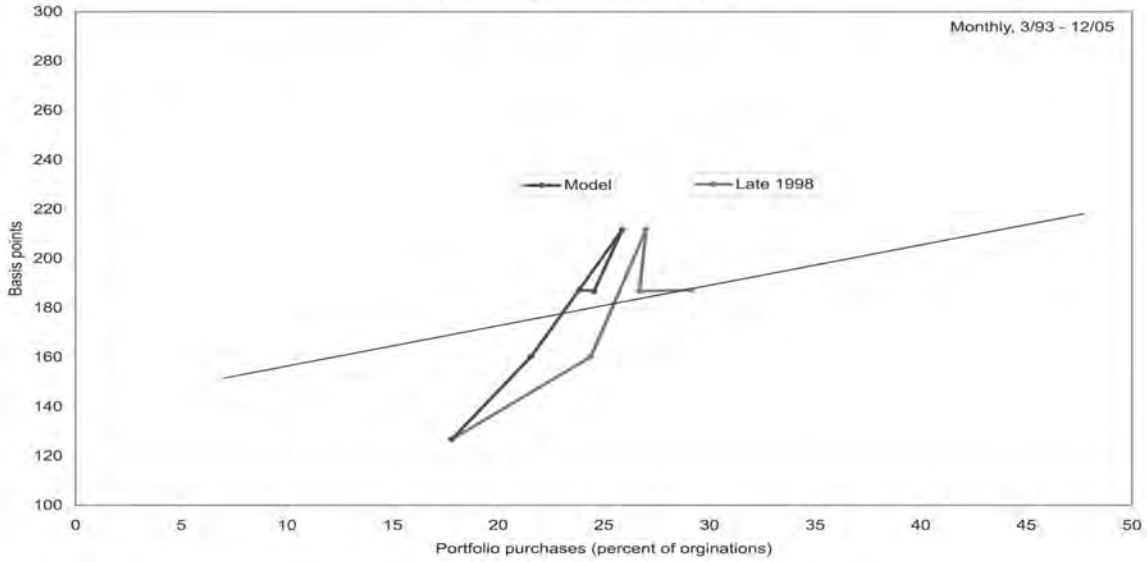
Secondary Market 30-year MBS Spread to Duration-matched Treasury and Retained Portfolio Purchases



- Positive relationship between spreads and GSE purchases.
- Actual spreads widen in 1998;

19

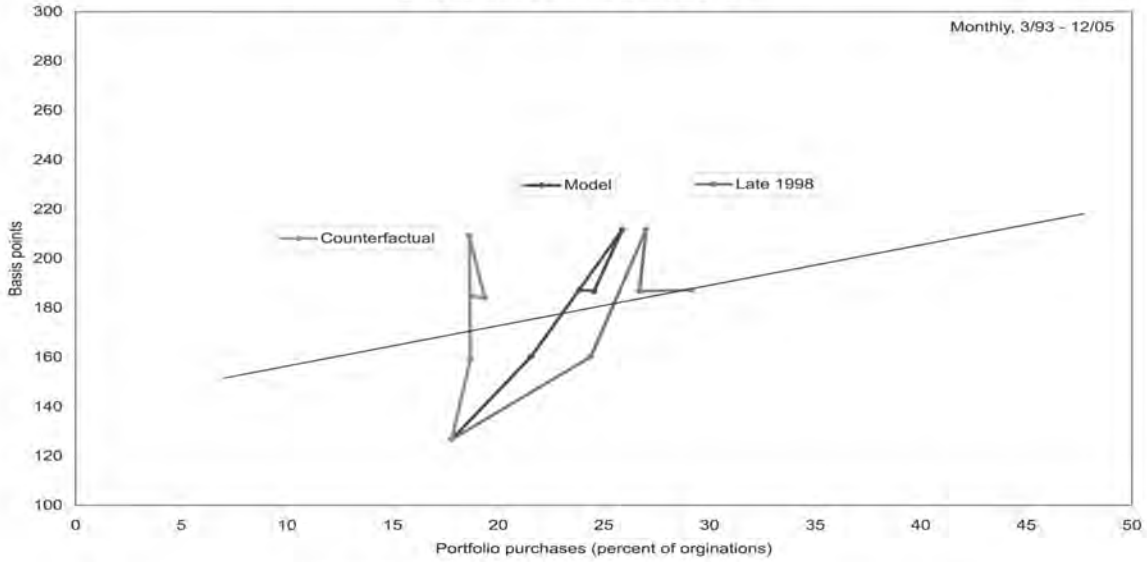
Secondary Market 30-year MBS Spread to Duration-matched Treasury and Retained Portfolio Purchases



- Positive relationship between spreads and GSE purchases.
- Actual spreads widen in 1998; GSEs behaved as expected during crisis.

20

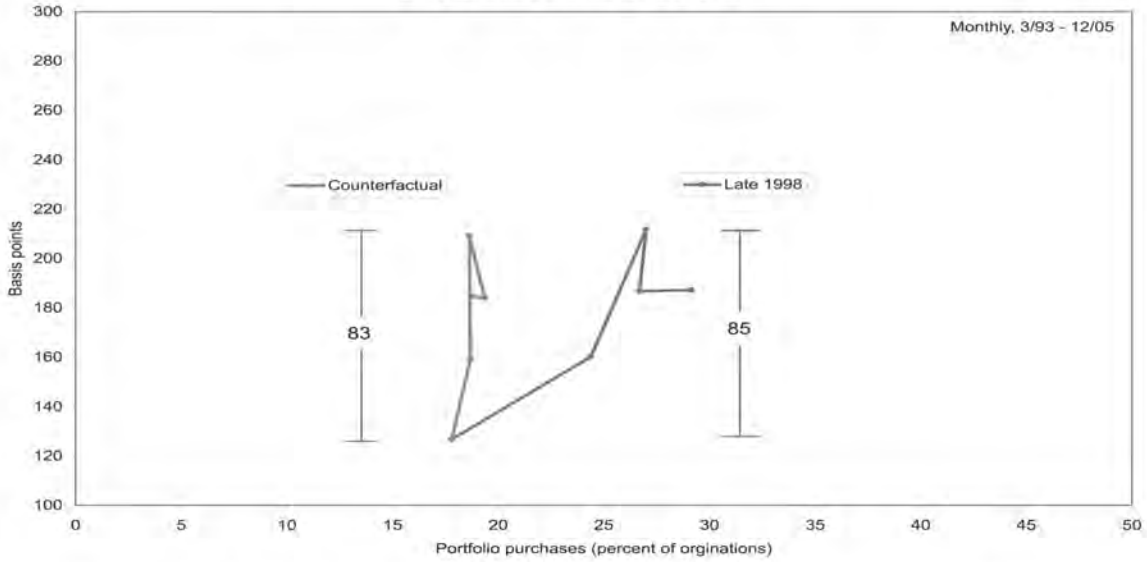
Secondary Market 30-year MBS Spread to Duration-matched Treasury and Retained Portfolio Purchases



- Positive relationship between spreads and GSE purchases.
- Actual spreads widen in 1998; GSEs behaved as expected during crisis.
- If GSE portfolio purchases unchanged during crisis, same widening of spreads.

21

Secondary Market 30-year MBS Spread to Duration-matched Treasury and Retained Portfolio Purchases



- Spreads widened 85 basis points when GSEs engaged in profit maximization.
- Spreads widened 83 basis points when they did not.
- Thus, GSE portfolios do not influence rates either in normal or abnormal times.

22

Why don•t GSE portfolios move mortgage rates?

Table 2
Total Cash and AA/AAA Securities (Governments, Corporate & Foreign Bonds)
(Year-end 2005 Estimates, Billions of dollars)

	CASH & US TREASURIES	AGENCY- & GSE-BACKED SECURITIES			AA/AAA CORPORATE & FOREIGN BONDS	TOTAL CASH & SECURITIES
		Debt	MBS	Total		
1. Fannie Mae and Freddie Mac	12	0	873	873	162	1047
2. Large Commercial banks	71	102	610	712	256	1039
3. Thrifts and Small Commercial banks	135	296	384	680	70	885
4. Insurance Companies, Mutual funds, State & Local government retirement funds, Brokers & dealers, and REITs	724	562	949	1511	1460	3695
5. Other (including foreign)	14705	1659	562	2501	1470	18676
Total liabilities	15647	2599	3678	6277	3418	25342

- Market is very large, about $25 trillion, and difficult for any single entity to influence rates.
- Total MBS held in GSE portfolio is 3 percent.
- Total MBS is 15 percent.

Refocusing Fannie and Freddie on Securitization

- GSE portfolios are too small to move rates but concentrate interest rate risk at two institutions, raising concerns about systemic risks.
- Results raise questions about the need for GSE portfolios, particularly to hold large amounts of their own MBS.
- Holding very large amounts of their own MBS in portfolio is a relatively recent development.
- Portfolios• only purpose is to boost GSE shareholders• profitability, with no obvious public benefit.
- But the large gross subsidy suggests that investors believe the taxpayer would cover the substantial costs associated with GSE financial distress.

GSEs Should Focus on Creating Publicly-Traded MBS

- Relying more on publicly traded MBS rather than GSE debt (GSE portfolio) for mortgage funding would:

  Allow more participants to manage a part of aggregate mortgage interest rate risks; thereby, the financial system would benefit from a more diverse opinion and range of hedging strategies.

  Provide a deep and liquid secondary mortgage market.

  Transmit benefits of secondary markets to homeowners.

  Moderate the size of the GSE implicit subsidy captured by GSE shareholders.

  Diminish moral hazard and reduce systemic risks associated with GSE portfolios.

  MBS is widely held by many market participants.

Table 2
Fannie Mae's Retained Portfolio
(End Year 2003)

		Dollars (Billions)	Percent of Assets
1	Total Assets	1,010	100
2	Loans held for securitization and sale	48	4.8
3	Non-Mortgage	59	5.8
4	Mortgage	902	89.3
5	MBS (Fannie & Other)	664	65.7
6	Whole Loans: Conventional, Fixed-Rate, Single-Family	195	19.3
7	Other	43	4.3
	Memo:		
8	Publicly Traded MBS	1,300	128.7

- Most of Fannie•s mortgage portfolio is MBS (65.7 percent).
- MBS is already a liquid asset.
- MBS means that the mortgage is already funded.
- Most mortgages are high quality; easily securitized.
- Much smaller portfolio would accommodate securitization and affordable housing goals.

The Federal Reserve Board Supports Proposals for GSE Portfolio Guidance that Incorporate the Following Key Features

- Presumption that all assets that can be securitized and sold to the public should not be held in GSE portfolios (eliminates •GSE arbitrage•).
- To hold in portfolio, an asset must be demonstrably mission-related (affordable housing or secondary market liquidity).
- GSEs would be permitted to hold assets needed for operational purposes (e.g., cash, business premises, etc.).
- Links portfolio directly to the affordable housing mission and properly focuses GSEs on securitization activities.
- Misleadingly referred to as •hard caps• or •numeric limits.•

What happens to GSEs' MBS ?

- MBS trades in world-wide and highly liquid market.
- When MBS rolls off the GSE portfolio, GSE debt is also extinguished.
- No change in net demand for mortgage assets.

Large Holders of GSE MBS

- MBS are held by insurance companies, mutual funds, and many other domestic private entities.
- Many foreign holders of GSE MBS.
- Large banks hold at least 20 percent of publicly traded MBS.
- Are banks more risky than GSEs?

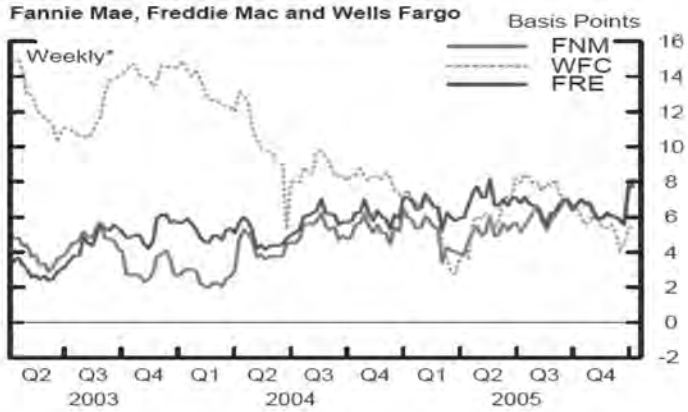
  Banks are well-diversified and well-capitalized.

  GSEs are monoline companies with high leverage.

Comparison of Systematic Risks of Large BHC and GSE Portfolios

- GSE senior debt is not affected by changes in credit risk.
- We use subordinated debt, which has meaningful systematic credit risk --- which is risk that is difficult for bond investors to hedge away.
- How is systematic risk changing over time at BHCs and GSEs?

Systematic Risk Components of Subordinated Debt for a BHC and GSEs
(Immediate response to systematic risk shock)



- Noticeable downward trend at BHCs, which suggests lower credit risk premiums.
- Measure of systematic risks at GSEs is constant or rising.
- In recent period, GSE sub-debt investors seemed more concerned about GSE risks or perceived diminished government guarantee for subordinated debt.

Conclusion (Part 1)

- GSEs have a substantial funding advantage.
- This funding advantage yields a large GSE subsidy.
- Much of the GSE subsidy is retained by GSE shareholders.
- The current GSE subsidy encourages the GSEs to hold large and highly leveraged MBS portfolios.
- The concentrations of MBS at Fannie and Freddie are able to go beyond what market forces would normally allow.
- Portfolio holdings have no effect on mortgage rates.

Conclusion (Part 2)

- Relying more on publicly traded MBS, and less on GSE debt, for funding mortgages would likely retain homeowner benefits and lessen financial system risks.

- Fannie•s and Freddie•s securitization activities, not the home mortgages and MBS that end up in their portfolio holdings, are what provide liquidity to mortgage originators.

- Fannie and Freddie would continue to be very profitable.

- Mission-only GSE portfolios would distribute MBS (including interest rate risk) into a deep and world-wide market.

Federal Reserve Papers

"The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates"
Real Estate Economics, 2005 V33: 427-463

"The GSE Implicit Subsidy and the Value of Government Ambiguity"
Real Estate Economics, 2005 V33: 465-486

"An Analysis of the Potential Competitive Impacts of Basel II Capital Standards on US Mortgage Rates and Mortgage Securitization"
http://www.federalreserve.gov/generalinfo/basel2/whitepapers.htm

"GSEs, Mortgage Rates, and Secondary Market Activities"
http://www.federalreserve.gov/pubs/feds/2005/index.html

"Monitoring Financial System Stability Using Fama-French Factors and Bond Market Data for Large Financial Institutions"
Forthcoming

Testimony of
Michael J. Heid
Co-President
Wells Fargo Home Mortgage

on behalf of
the Housing Policy Council
of the
Financial Services Roundtable

Before the House Financial Services Committee
Of the
United States House of Representatives
On

The Future of Housing Finance – A Review of Proposals to Address Market Structure and Transition

September 29, 2010

Mr. Chairman and Members of the Committee, my name is Mike Heid, and I am Co-President of Wells Fargo Home Mortgage. I also am the chairman of the Housing Policy Council ("HPC") of The Financial Services Roundtable, and I am appearing today on behalf of the Housing Policy Council. The Housing Policy Council represents 30 of the leading national mortgage finance companies. HPC members originate, service and insure mortgages. HPC member companies also are major customers of and business partners with Fannie Mae and Freddie Mac.

For many years, and even throughout the financial crisis, Fannie Mae and Freddie Mac performed their secondary market functions efficiently and effectively. It is now very apparent, however, that there were some fundamental flaws in the old GSE model. For example, a lack of adequate supervision and regulation created the opportunity for the GSEs to employ excessive leverage and to grow their portfolios in excess of what was necessary to achieve their original objectives.

Dodd-Frank Act

The financial crisis also revealed flaws in the originate-to-distribute model of mortgage finance. The Dodd-Frank Act seeks to address those flaws by aligning the interests of consumers, lenders and investors to ensure borrowers consistent, fair and equitable access to housing finance and to rejuvenate the secondary market

for mortgage securities. Implementation of the Act will require a thoughtful coordination of various related regulations and accounting practices and a careful balancing of the fundamental objective of the Act with the need to attract sufficient capital to the housing finance system. It also requires that provisions – such as risk retention – be implemented in a way that does not reduce access for credit worthy borrowers.

The new standards required by the Dodd-Frank Act will have a significant impact on mortgage lending standards and securitization. These standards will also greatly influence the secondary market changes to the GSE system that we are discussing today. In short, stronger underwriting standards and risk retention requirements will make the abuses that occurred in the past unlikely to be repeated, and these new standards will have a dramatic impact on the quality of loans that are securitized. Lenders have already implemented stronger underwriting standards, and the current GSEs have tightened their standards and have put many more requirements on originators for the loans that they will purchase and the buy-back requirements for lenders on loans that do not perform.

HPC Proposal

HPC has developed a proposal for addressing the problems inherent in the structure of Fannie Mae and Freddie Mac which I would like to outline for you today. Our proposal is intended to achieve several objectives:

- Encourage private sector capital to support the secondary mortgage market;
- Ensure a steady flow of reasonably priced conventional mortgages to borrowers;
- Limit the role of the Federal Government and the risks taken by the taxpayer in the secondary mortgage market; and
- Provide a flow of funding to support affordable owner-occupied and rental housing.

We propose to achieve these objectives by dividing the existing functions of Fannie Mae and Freddie Mac among a combination of public and private sector entities.

Privately Capitalized "MSICs" Should Assume Credit Enhancement Function of the GSEs

A central feature of our proposal is the creation of new privately capitalized firms to perform the credit enhancement or guarantee function of the GSEs. Currently, the GSEs purchase mortgages from mortgage originators, package those mortgages into securities, and guarantee the payment of interest and principal on

those securities. In exchange for the guarantee, the GSEs charge mortgage originators a "guarantee fee." We propose that these functions be assumed by privately capitalized firms called mortgage securities insurance companies, or "MSICs."

A MSIC would --

- purchase conventional mortgages from mortgage originators;
- guarantee the payment of principal and interest on the securities; and
- charge mortgage originators a fee for the guarantee.

Under our proposal, these privately capitalized entities would be chartered and supervised by the Federal Government, much like national banks and federal savings and loans are chartered and supervised by the Federal Government. However, they would not be backed by the Federal Government, either explicitly or implicitly.

We do not propose a particular organizational structure for the MSICs. Instead, we propose that the investors in a MSIC determine the most appropriate organizational and governance structure for the entity. The validity of the organizational structure and the ability of the investors to manage the entity would be reviewed as part of the chartering process.

We believe multiple MSICs are needed but do not call for a specific limit on the number. We assume that at least 4 will be needed to serve the market, but

probably not more than 8 are necessary. The greater the number of MSICs, the better insulated the housing finance market would be from the failure of any one MSIC. On the other hand, too many MSICs -- with different underwriting systems and procedures -- could be overly burdensome to lenders, particularly smaller lenders.

An Explicit – But Limited -- Federal Guarantee is Needed

An explicit federal guarantee is needed to ensure a steady flow of mortgage finance at a reasonable cost to borrowers. While MSICs would not be backed by the Federal Government, our proposal does call for the Federal Government to provide an "explicit" backup or catastrophic guarantee on the mortgage securities that are issued by MSICs. To be clear, this guarantee would not apply to the MSICs themselves; it would guarantee the payment of principal and interest to investors in mortgage backed securities packaged by MSICs. A MSIC would pay a fee to the government for this guarantee, and this fee would be placed in a reserve.

The challenge we face is designing a secondary market system that ensures a steady flow of reasonably priced mortgages to borrowers while limiting the exposure of taxpayers. Our proposal addresses this challenge by putting several

layers of private capital in front of the federal guarantee, and as I discuss below, subjecting MSICs to "world class" regulation.

Standing before the federal guarantee would be --

- The down payment on a mortgage made by the homebuyer;
- Any private mortgage insurance or other credit enhancement on the mortgage loan;
- The shareholder's equity in the MSIC; and
- The reserve established by fees paid by MSICs in return for the government's guarantee.

These layers of private capital should insulate the taxpayers from paying claims on the guarantee. However, in the event that all of these private resources are exhausted and the Federal Government is called upon to make payments under the guarantee, we support the imposition of a "special assessment" on MSICs to recoup any costs incurred by the government. Thus, the system we propose would operate much like the Federal Deposit Insurance Fund does today.

Finally, if the fees for the federal guarantee are set properly, the federal guarantee would be budget neutral. Under existing federal credit procedures, the cost of federal credit activity in a budget year is the net present value of all expected future cash flows from guarantees and direct loans disbursed in that year. For loan guarantees, cash inflows consist primarily of fees charged to insured borrowers, and cash outlays consist mostly of payments to lenders to cover the cost

of loan defaults. FHA and Ginnie Mae are models for this budgetary treatment. In the case of both FHA and Ginnie Mae, the fees paid for the federal guarantee normally cover claims on the guarantees and other operational expenses.

Capitalizing MSICs

Attracting sufficient private capital to MSICs is a key to the success of our proposal. We assume that the banking industry could be one such source of capital for MSICs since the industry relies upon the existence of a strong secondary mortgage market. Therefore, we propose that banking organizations of all sizes be authorized – but not required – to invest in MSICs. This would permit MSICs to be formed by a consortium of large banks as well as a group of small banks.

We also have tried to gauge the interest of other potential investors. We have done so by previewing our proposal with investments bankers and other industry experts. We have been told that investors would be interested in capitalizing MSICs as long as they could achieve a "reasonable" return on their investment *and* that the relationship between MSICs and the Federal Government was clear and unchanging.

Based upon this feedback, we have undertaken an effort to quantify the capital standards, fee structures, and returns needed to attract private capital and to assess the impact of this structure on mortgage rates. That analysis has involved

the application of various stress tests to project capital levels needed to cover potential losses. It also has involved the identification of a "reasonable" rate of return on capital. We will provide the Committee with our final analysis when it is complete.

World Class Regulator

To ensure the safe and sound operation of MSICs – and further reduce the need for the Federal Government ever to perform on its guarantee – we propose that MSICs be subject to "world class" regulation, by a strong and independent federal regulatory agency. This regulatory regime should include:

- Strong prudential standards – MSICs' should be subject to capital, liquidity and other prudential standards set by the chartering agency;
- Underwriting Standards for Mortgages in MBS – MSICs should be prohibited from purchasing mortgages that do not meet underwriting standards set by the chartering agency. These standards should provide that mortgages purchased by in a MSIC are prudentially underwritten.
- Loan Limits – The federal chartering agency should set, by regulation, limits on the size of mortgages that could be included in mortgage backed securities insured by a MSIC.

- Portfolios -- MSICs should not be permitted to establish and hold portfolios purely for investment purposes. Small portfolios should be permitted to facilitate the development of new products and certain types of loans for which there are limited markets such as multifamily mortgages. MSICs also could use this portfolio capacity to warehouse loans before securitization, to purchase whole loans from smaller banks and for loss mitigation and REO disposition purposes.

Central Securitization Facility and a Single MBS

Our proposal also calls for the creation of a single MBS Securitization Facility to provide administrative services related to mortgage backed securities (MBS) packaged by MSICs. The Facility would process payments on those MBS from the lenders/servicers to the investors. It also would place and administer the federal catastrophic guarantee on the MBS. In other words, this Facility would perform functions similar to those performed by Ginnie Mae for FHA. We recommend that the Facility be part of the Federal Government, and that Ginnie Mae be tapped to perform the services of the Facility, either directly or on a contract basis.

The creation of this Facility also would facilitate the creation of a single mortgage backed security. Today, there are some differences in the terms and

repayment characteristics of the MBS marketed by the two GSEs. These differences can, from time to time, result in differences in market liquidity. We propose that all MSICs be required to adhere to a standard form of MBS that has the same repayment terms and other conditions. A single MBS would promote better understanding of the MBS by investors, and it would enhance the liquidity of the market. This would help ensure home buyers have consistent access to reasonably priced home financing.

A single MBS does not mean that all MBS would be composed of the same type of mortgages, only that the basic legal structure, terms and conditions governing repayment and other administrative features of the MBS would be the same. MBS backed by MSICs could be composed of loans from a single lender or multiple lenders allowing lending institutions of all sizes access to this liquidity.

Like existing GSE securities, these MBS should be exempt from SEC registration requirements. Such an exemption is necessary to maintain the "To Be Announced" (TBA) market. The TBA market is used by the lending industry to reduce risks in the origination process and reduce borrowing costs for consumers. The TBA market allows borrowers to lock in rates in advance of closing a mortgage loan and permits lenders to hedge the corresponding interest rate risk. The TBA market is based upon a trade of a MBS on a future date, and at the time of the trade the MBS to be included in the trade may not be identified. Therefore, it

is impractical to apply standard SEC registration and disclosure requirements. To overcome this practical problem, the GSEs currently disclosure information to investors about the composition of each pool of mortgages backing a security, including the average loan-to-value ratio, the average debt-to-income ratio, the average borrower credit score, the number and value of mortgages from each State, the distribution of mortgage coupon rates, and whether the mortgages were originated in broker or non-broker channels. MBS issued by MSICs should be subject to a similar disclosure requirement.

Affordable Housing

Finally, we propose that MSICs assume the responsibility for supporting owner-occupied and rental housing for extremely-low and very-low income families imposed upon the GSEs in the Housing and Economic Recovery Act. That Act directed the GSEs to annually set aside approximately 4 basis points of the total dollar amount of new mortgages that they acquire and transfer 65 percent of such amount to the Housing Trust Fund and 35 percent of such amount to the Capital Magnet Fund.

The Housing Trust Fund, which is to be administered by HUD, would provide grants to the States primarily for the production, preservation and rehabilitation of rental housing for extremely low-income and very low-income

families. The Capital Magnet Fund, which is to be administered by the Treasury Department, is designed to leverage private sector capital for the development of housing for extremely low-income families, very low-income families, and low-income families. It also is designed to promote economic and community development projects to help such families. We support this transfer payment in lieu of the application of specific housing goals on MSICs. MSICs should not be subject to specific housing goals.

Transition

While in conservatorship, both Fannie Mae and Freddie Mac have performed their three primary responsibilities well: continuing to promote liquidity for housing finance, finding solutions to help keep borrowers in their homes, and conserving the assets of the two enterprises. Without the continued operation of Fannie Mae and Freddie Mac during the crisis, the flow of housing finance would have been severely disrupted. It continues to be imperative that they operate as they are today until the future state is well defined and a careful transition is formulated.

Key transition issues that must be considered include:

- The transition must ensure borrowers have uninterrupted access to reasonably priced housing finance along with other benefits they enjoy

today (for example, access to 30 year fixed rate mortgages and the ability to lock a rate while loans are in process).

- The transition must ensure the continued liquidity of today's agency MBS market and the 'to be announced' (TBA) MBS market in particular which allows lenders to better insulate consumers from the uncertainty of markets and to hedge their risks (thereby reducing borrowing costs).
- The transition must seek the right balance between sufficient capitalization of future credit risk guarantors and how different capitalization requirements impact the costs of home ownership for consumers.
- The transition should also seek to achieve an explicit government guarantee of the MBS with as little actual government risk as possible (achieved by placing sufficient private capital in front of the government).
- The transition must find a fair and equitable way to deal with the legacy assets and liabilities of Fannie Mae and Freddie.
- The transition should seek to preserve the valuable infrastructure of Fannie Mae and Freddie Mac.

- The transition must ensure low and extremely low income borrowers have access to housing while avoiding lending requirements and/or targets for private lenders/guarantors.
- In order to ensure that markets have sufficient time to evaluate and prepare for the transition, the transition should be allowed sufficient time for proposed changes to be clearly communicated. Where possible, gradual steps should be used and 'tested' before proceeding to broader implementation. Given the size, importance, and complexity of the housing finance system, expectations should be for this transition to potentially take multiple years to be realized.

A Note on Other Proposals

Many of the other proposals are very closely aligned with HPC's, and while some call for more or less government involvement, all agree that promotion of liquidity for housing finance is the objective. Several recommendations also call for an explicit guarantee of MBS (not the corporate entities) and for stronger capitalization and regulation. We believe that those recommendations that call for complete nationalization miss the benefits to consumers of innovation and efficiency that private capital will allow and expose the taxpayer to more risk than is necessary to optimize MBS liquidity. Recommendations to completely privatize

miss the necessity of a government backstop to ensure consistent functioning of MBS markets under all economic conditions.

Conclusion

Thank you for the opportunity to explain our proposal. The members of the Housing Policy Council are committed to pursuing this concept, and welcome the opportunity to work with the Committee as it develops its own proposals and reforms.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM RIC CAMPO

Q.1. In your testimony you described a difference in how European multifamily properties were built and marketed as compared to their U.S. counterparts.

Could you describe further why this difference is important as it relates to covered bonds and multifamily properties?

A.1. *NMHC/NAA Response:* The basic issue for the multifamily industry is the limited information about covered-bond financing for multifamily properties that is comparable to how apartments are financed in the United States. The development and long-term financing in Europe and the United States is not an apples-to-apples comparison due to the fact that in Europe the individual rental units in a property are mortgaged, much like a condominium here in the United States. Therefore, there is no commercial real estate mortgage based on the collective income from the rental units and so we can not gain the needed understanding on the impact of covered-bond mortgage financing upon development trends and the needed financing needs to support the asset base over a long-term hold period.

Most European countries, and in general most countries outside of the United States, rely on a condominium approach to develop and for ownership of rental housing. In Europe the development of rental apartment properties are typically financed based on presale of the units and what would be an end-loan/construction loan. This short term loan is made and secured on the capital from the presale and obligations by the individual unit owners. The role of covered bonds in rental housing is in the financing of the individual unit mortgages, which is more analogous to the single-family residential home mortgage market in the United States.

Q.2. What additional important differences do you see between the U.S. and European markets, as it relates to multifamily properties, that you would recommend this Committee carefully examine?

A.2. *NMHC/NAA Response:* We would urge the Committee to seek detailed information from the European Covered Bond Council that provides historical loan origination and performance information by asset class and in particular commercial real estate to better understand how the loans have performed and the extent of the use of covered-bond credit to serve the commercial real estate sector. It would be useful to understand how the issuer looks at diversification of assets, how they perform the underwriting associated with the commercial real estate and the specific underlying loan terms of the covered bonds associated with commercial income properties.

Q.3. In Mr. Campo's testimony he states that it is his belief that covered bonds will not lead to new lending, but rather banks would simply replace some of their whole loans activities with covered bonds. There also has been speculation, given the similarities between covered bonds and advances from the Federal Home Loan Banks, that a covered-bonds system simply would replace a portion of those advances.

Based upon your studies and experiences, do you believe a properly designed covered-bonds system to be a tool that will allow fi-

nancial institutions to shift existing activity, or do you see this as additional activity that will increase funding, and thus lending?

A.3. *NMHC/NAA Response:* Our view is the legislative proposal offered creates the opportunity for banks to issue loans, but there are issues related to risk-based capital, especially that associated with liabilities of replacement assets and funding the transfer in the event of financial institution failure. We believe that the institution failure can be addressed by the banking regulators, but we do not feel the covered-bond issuance is less risky than the whole loan execution and as noted the potential replacement of advances of FHLBs.

Our conclusion is that covered-bond issuers would most likely transfer credit activity from whole loans to covered bonds rather than expanding credit in a heightened environment of risk management. Covered bonds do not dramatically address the ability to reduce risk to the issuer beyond other credit offerings.

Q.4. If simply a shift, where do you see the shift occurring and why do you believe it beneficial, or not, under those circumstances?

A.4. *NMHC/NAA Response:* The FHLB system has limited capacity to serve the multifamily mortgage market. We see the shift primarily occurring among existing bank loan activities and source of capital upon which they extend credit.

Q.5. The implicit guarantee provided to Fannie Mae and Freddie Mac ultimately cost the American taxpayer hundreds of billions of dollars. Any changes we make to our home finance system must ensure that the taxpayers never again are exposed to this kind of a danger.

If a covered-bond system was to be designed and enacted, what components would be essential to ensure that the system did not carry this same implicit guarantee?

A.5. The issue of replacement of credit from Fannie Mae and Freddie Mac is the core issue for multifamily as it considers alternative credit in the market. The apartment industry is heavily regulated at the State and local level, it is a fragmented industry composed of thousands of owners large and small and as such relies on a variety of sources of credit from private sources, banks and thrifts, Wall Street conduits, insurance companies, FHA and Fannie Mae and Freddie Mac. Loans to the apartment sector must take into consideration the unique and individual circumstances of each property, the market, tenancy, ownership structure, and financing needs. Therefore it is very important to have a range of credit options that are both national and locally based.

With the exception of Wall Street conduit loans, the credit sources available to the apartment sector have managed their lending activities well and have not contributed to the financial crisis. As the impacts of Dodd-Frank improve the oversight and risk mitigation in securities-based credit, the future expectation is for prudent lending to the apartment sector from Wall Street conduits. There is no cost to the taxpayer associated with the current financial crisis, as the losses suffered by Wall Street firms; banks, private capital, and even Fannie Mae or Freddie Mac were not a result of multifamily lending. In fact, the Fannie Mae and Freddie Mac multifamily programs are a model for prudent risk manage-

ment and underwriting. Seeking a credit replacement should not be associated with their past lending practices in multifamily activities.

Therefore, we would recommend that the covered-bond program use the GSE model for multifamily lending and take the policies and procedures used to purchase loans from the GSE lenders as a way to originate, service and manage risk with Government backing.

Q.6. Many experts feel that it would be economies of scale that could make covered bonds a viable tool for liquidity. Therefore, there is some debate as to how or if community and regional banks would be able to participate in the covered-bonds market.

What is your opinion on the likelihood that covered bonds could be an effective tool for them and why do you believe this to be the case?

A.6. The question is not an area where NMHC and NAA can offer relevant expertise and comment.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

PREPARED STATEMENT OF THE AMERICAN SOCIETY OF CIVIL ENGINEERS

The American Society of Civil Engineers (ASCE)[1] would like to thank the Senate Banking, Housing, and Urban Affairs Committee for holding a hearing today on proposals to create a National Infrastructure Bank. The Society is pleased to present to the Committee our views on investing in the Nation's infrastructure. ASCE supports the creation and operation of a National Infrastructure Bank.

ASCE's 2009 Report Card for America's Infrastructure graded the Nation's infrastructure a "D" based on 15 categories (the same overall grade as ASCE's 2005 Report Card), and stated that the Nation needs to invest approximately $2.2 trillion over the next 5 years to maintain the national infrastructure in a state of good repair. Even with the current and planned investments from Federal, State, and local governments in the next 5 years, the "gap" between the overall need and actual spending will exceed $1 trillion in 2014. If the Nation continues to under invest in infrastructure and ignores this backlog until systems fail, we will incur even greater costs.

The total of all Federal spending for infrastructure as a share of all Federal spending has steadily declined over the past 30 years, according to the Congressional Budget Office. The results of years of under investment can be seen in traffic and airport congestion, unsafe bridges and dams, deteriorating roads, and aging drinking water and wastewater infrastructure. ASCE is concerned with this accelerated deterioration of America's infrastructure, with the general reduction in investment for the preservation and enhancement of our quality of life, and with the threatened decline of U.S. competitiveness in the global marketplace.

As Congress is in the process of developing a comprehensive multiyear surface transportation authorization, and as President Obama rolls out the Administration's plan to invest $50 billion on the Nation's infrastructure, our roads, bridges, dams, and water systems continue to remain in a state of decline. Aging and overburdened infrastructure threatens the economy and quality of life for all Americans. However, while the problem may appear staggering, innovative financing such as a National Infrastructure Bank, could provide a fiscally prudent means to begin repairing our Nation's deteriorating infrastructure.

Innovative financing techniques can greatly accelerate infrastructure development and can have a powerful economic stimulus effect. Currently, the burden of infrastructure funding is shifting from Federal to State and local resources to fund the growing need for improvements. Innovative programs in SAFETEA–LU, such as the establishment of the State Infrastructure Bank program, have been a good start, but more needs to be done to expand their scope, and new programs or approaches must be introduced. The Nation must develop and authorize innovative financing programs that not only make resources readily available, but also encourage the most effective and efficient use of those resources. Federal investment must be used to complement, encourage, and leverage investment from the State and local government levels as well as from the private sector. In addition, users of infrastructure must be willing to pay the appropriate price for their use.

ASCE supports innovative financing programs for transportation projects and believes the Federal Government should make every effort to develop new programs or flexibility in innovative procurement approaches. President Obama's newly released infrastructure investment plan proposes the permanent creation of a national infrastructure bank, which could leverage private capital for projects of national and regional significance. This sort of proactive thinking toward infrastructure will allow States to come together for regional projects such as high speed rail and can move the Nation's infrastructure forward. ASCE applauds President Obama's leadership on the issue and believes that the Administration's investment plan has great potential to be a part of the solution. In particular, the President's call to establish a national infrastructure bank is a concept ASCE long has supported.

The National Infrastructure Bank Act of 2009 would begin to address a problem that is rapidly approaching crisis levels. Briefly the legislation would establish a National Infrastructure Bank, which would be an independent body designed to evaluate and finance infrastructure projects of substantial regional and national signifi-

[1] ASCE was founded in 1852 and is the country's oldest national civil engineering organization. It represents more than 146,000 civil engineers individually in private practice, Government, industry, and academia who are dedicated to the advancement of the science and profession of civil engineering. ASCE is a nonprofit educational and professional society organized under Part 1.501(c) (3) of the Internal Revenue Code.

cance. Eligible projects would range from mass transit systems, roads, bridges, drinking-water systems, and sewage treatment systems. The bill would begin the process of meeting the Nation's broad infrastructure needs, while selecting those projects which will be most beneficial.

ASCE supports the creation and operation of a National Infrastructure Bank, which should leverage public funds with private dollars to invest in transportation, environment, energy, and telecommunications projects of significance. Each infrastructure system should have a dedicated source of revenue that is independent of the Federal Government's annual appropriations process. This ensures that the owners and managers of publicly owned treatment works and other systems will be able to finance improvements to their physical infrastructure in a systematic, long-term program that avoids the volatile atmosphere surrounding yearly spending authorizations.

However, an infrastructure bank should adhere to certain key requirements:

- The bank should be capitalized initially by general fund appropriations and should be self-sustaining after the initial start-up period.
- The bank should develop financing packages for selected projects which could include direct subsidies, direct loan guarantees, long-term tax-credit general purpose bonds, and long-term tax-credit infrastructure project specific bonds.
- The bank should not replace existing infrastructure funding and financing mechanisms, but act as a supplement to leverage Federal, State, local, and private infrastructure financing.

Additionally, ASCE encourages an infrastructure bank where public works projects must meet the continuing needs to provide natural resources, industrial products, energy, food, transportation, shelter, and effective waste management, while at the same time protecting and improving environmental quality. Sustainability and resiliency must be an integral part of improving the Nation's infrastructure. Today's transportation systems, water treatment systems, and flood control systems must be able to withstand both current and future challenges. Infrastructure systems must be designed to protect the natural environment and withstand both natural and man-made hazards, using sustainable practices, to ensure that future generations can use and enjoy what we build today.

Furthermore, a National Infrastructure Bank should allow States to make the ultimate decision on which projects receive financing from the Federal bank based on established priorities. The bank however, should retain sufficient oversight to guarantee an equitable distribution of funds and to ensure that all eligible projects are able to compete for financing on a relatively even footing.

Without long-term financial assurance, the ability of the Federal, State, and local governments to do effective infrastructure investment planning is severely constrained. Therefore, in addition to a National Infrastructure Bank ASCE also supports:

- User fees (such as a motor fuel sales tax) indexed to the Consumer Price Index.
- Appropriations from general treasury funds, issuance of revenue bonds, and tax-exempt financing at State and local levels.
- Trust funds or alternative reliable funding sources established at the local, State, and regional levels, including use of sales tax, impact fees, vehicle registration fees, toll revenues, and mileage based user fees to be developed to augment allocations from Federal trust funds, general treasuries funds, and bonds.
- Public–private partnerships, State infrastructure banks, bonding and other innovative financing mechanisms as appropriate for the leveraging of available transportation program dollars, but not in excess of, or as a means to supplant user fee increases.
- The use of budgetary firewalls to eliminate the diversion of user revenues for noninfrastructure purposes.

ASCE is concerned with the accelerated deterioration of America's infrastructure, with the general reduction in investment for the preservation and enhancement of our quality of life, and with the United States' continued competitiveness in the global marketplace. As stewards of the Nation's infrastructure, civil engineers must be a voice in the national debate on infrastructure. ASCE has and will continue to support innovative financing programs that not only make resources readily available, but also encourage the most effective and efficient use of those resources. However, financing alternatives such as a National Infrastructure Bank, cannot replace a public commitment to funding. Financing by any technique does not supplant the need for adequate user fees or other funding sources to eventually pay for projects.